Clerk of the Board
California Air Resources Board
1001 I Street, Sacramento, California 95814
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IETA COMMENTS ON CALIFORNIA AIR RESOURCES BOARD'S PROPOSED CAP-AND-TRADE AMENDMENTS & RELATED DOCUMENTATION

The International Emissions Trading Association (IETA) appreciates this opportunity to provide comments in response to the California Air Resources Board's (ARB) Proposed Amendments to the California Cap-and-Trade Program and associated regulatory package including the proposed Mine Methane Capture Offset Protocol. We thank you for considering IETA's perspectives on the matter.

ABOUT IETA

IETA is dedicated to the establishment of market-based trading systems for greenhouse gas emissions that are demonstrably fair, open, efficient, accountable, and consistent across national boundaries. IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our 140 member companies include some of North America's, and the world's, largest industrial and financial corporations—including global leaders in oil & gas, mining, power, cement, aluminum, chemical, pulp & paper, and investment banking. IETA also represents a broad range of global leaders from the industries of: data verification and certification; brokering and trading; offset project development; legal and advisory services.

OVERVIEW

IETA's comments are structured around six topics:

1. **Compliance Unit Surrender Order;**
2. **Holding Limits and Limited Exemption;**
3. **Registration with ARB;**
4. **Transaction Reporting Requirements;**
5. **Cost Containment; and**
6. **Mine Methane Capture Offset Protocol**

1. COMPLIANCE UNIT SURRENDER ORDER

IETA's membership has a strong preference for individual entities to be given the flexibility to indicate which compliance units they would like to surrender. We appreciate the need to provide a default surrender order in case an entity fails to indicate its own surrender order, but this default order should not supersede an entity's preference, if indicated. We understand that the Compliance Instrument Tracking System Service (CITSS) currently does not have the functionality to allow entities to indicate their own retirement order preference, but our membership contends that the benefits of implementing such functionality outweigh the cost. Some tax and accounting considerations follow.

Tax and Accounting Considerations:

ARB officials may wish to consider the EPA's Acid Rain Program in determining the importance of an entity's ability to choose which compliance units it retires in light of tax implications. In the Acid Rain Program, an entity has the option to choose to retire specific allowances based on their tax basis (this is often referred to as "specific identification" by the accountants).

For tax purposes the basis of a freely allocated allowance is zero. That contrasts with a purchased allowance, where for tax purposes the basis would be the purchase price. An entity can then choose to retire an allowance based on its tax basis. In the Acid Rain Program, since SO2 allowances are treated as a capital asset, a company could choose allowances based on how it would impact its capital gains posture for a given year.

According to a Journal of Accountancy report, approximately three quarters of companies value freely allocated allowances at zero, and purchased allowances at cost[1]. With this in mind, entities may want to choose to retire compliance units in a different order than is proposed by ARB. Different entities will have different financial drivers depending on their industry, financial situation, accounting policy, etc. – so while one company may wish to retire freely allocated allowances first, another may wish to do the opposite. Similarly, one company may wish to retire earlier vintages first, and another may wish to retire later vintages first. Consider the following example:

A company in California is expected to emit 100 tons of GHGs per year in 2013 and 2014, and ARB allocates 80 allowances/year for free (i.e. 80 vintage 2013 allowances and 80 vintage 2014 allowances) leaving a shortfall of 20 tons/year that must be bought in the marketplace.

Assume that this company is concerned about rising costs, so it buys 40 tons of vintage 2013 allowances (the most liquid contract) in the marketplace at $15/ton to hedge its price risk. The regulation allows the company to use vintage 2013 allowances for compliance with 2013 or 2014 emissions.

Assume, now, that for whatever reason (perhaps production was down), that company only actually emitted 90 tons in 2013 and 90 tons in 2014. This leaves it with 20 surplus allowances, which it banks for 2015.

The regulation says that ARB will retire allowances in a specific order, starting with the earliest vintages (i.e. all vintage 2013s will be retired first). So in the company's registry account, it is left with 20 vintage 2014 allowances. Since all of these were allocated for free, this would be valued at zero on the company's balance sheet.

However, depending on the company's inventory/accounting policy, that company may actually prefer to retire all freely allocated allowances first (including all vintage 2014s), leaving them with 20 vintage 2013 allowances instead (which they value at cost).

[1] Journal of Accountancy Access here: http://www.journalofaccountancy.com/Issues/2009/Jul/20081312

As this example points out, there are important accounting considerations that make it important that an entity has the option to choose its own compliance unit surrender order depending on different circumstances. IETA encourages ARB to provide this capability within CITSS.

2. HOLDING LIMITS AND LIMITED EXEMPTION

IETA has previously detailed why holding limits in California's program pose a systematic disadvantage to large final emitters (LFEs) whose emissions exposure may be greater than the holding limit itself. The holding limit prevents these LFEs from accessing the full benefits of banking allowances, an important cost containment mechanism within the cap-and-trade program.

IETA maintains that with the additional market oversight provisions that ARB has effectively put into place, a holding limit is not necessary to prevent market manipulation. *If* a holding limit must be in place, IETA reiterates that it should be made relative to an entity's compliance obligation so that it does not disproportionately affect LFEs.

Compounding the problem the holding limit presents is the automated compliance surrender order that is outlined in the section above, and with that the proposal to eliminate annual compliance surrender obligations.

With ARB no longer retiring 30% of an entity's compliance obligation per year (in non-compliance years) – and without an entity permitted the ability to voluntarily surrender compliance units in non-compliance years to satisfy its compliance obligation – an entity must carry an additional number of compliance units in its compliance account (equal to 30% of its annual emissions obligation).

Since the limited exemption has not changed, and because an entity now must hold an additional 30% of its annual compliance obligation instead of being retired, it further squeezes the amount an entity can hold in its compliance account. For smaller entities this might not pose a problem. However, for LFEs carrying a significant compliance obligation, who must store units in their compliance account because the holding limit prevents them from holding a requisite number of units in their holding accounts, this is a significant problem.

IETA suggests two solutions:

1. Eliminate or increase holding limits so that LFEs are not disproportionately burdened compared to the rest of the market. Doing so would eliminate much of the concern regarding ARB's proposal to eliminate the annual compliance surrender obligation (though there would still be issues with the automated compliance surrender order).
2. Allow entities to surrender compliance instruments at any time (to count against their compliance obligation). Doing so would alleviate the limitation to compliance account holdings, particularly with the limited exemption not being adjusted.

3. REGISTRATION WITH ARB

A. Section 95830 (c)(1)(H): Identification of Corporate Associations

Section 95830 of the proposed amendments makes a change within the program registration requirements that requires identification of all other entities with whom the entity has a corporate association, direct corporate association, or indirect corporate association. In the previous regulation, these association disclosures were only required for associated entities registered pursuant to the program. The new proposal significantly expands the requirement for identification to associations far beyond the reach of the California program.

A number of IETA's members are large corporations with many corporate associations across the globe. For some IETA members, the number is in excess of 1000 affiliates and subsidiaries. The requirement as outlined in the amendments would be very difficult to maintain as hundreds of these associations are constantly changing, making submitted lists obsolete soon after submittal to ARB. Given the magnitude of what is being required, IETA wonders if ARB itself would view it as worthwhile to undertake the management of such a large influx of information.

Further, IETA is unsure why it is of interest to ARB to have record of corporate associations for entities not registered or otherwise involved in the cap-and-trade program. Unless there is some rationale that IETA is not aware of, we recommend reverting to the language as written in the current regulation.

B. Section 95830 (c)(1)(I): Identification of Persons with Access to Information

Section 95830 adds language that would require entities to provide ARB with contact information for "all persons employed by the entity in a capacity giving them access to information on compliance instrument transactions or holdings, or involving them in decisions on compliance instrument transactions or holdings".

IETA believes this language is overly broad and unnecessary. Within a large company, the list of people who could have access to information could be in the hundreds, and would be very fluid. To maintain a contact list of each of these employees is burdensome and unrealistic. The proposed regulatory language is general, and there is no discernable threshold for access or involvement. How should a situation be treated if a person normally unconnected to the issue offers unsolicited advice in an impromptu discussion?

These registration requirements also pose problems for offset project developers who may work with external entities (consultants, project owners, etc.) to manage projects. For example, within an Ozone Depleting Substance (ODS) destruction project, there could be many technicians who know the number of credits accruing due to the amount of ODS that is being destroyed in the incinerator. Would this constitute knowledge of compliance instrument holdings? Would these technicians need to be listed in the registration?

IETA recommends this proposed amendment be struck.

C. Section 95830 (c)(7): Registration of Account Viewing Agents

The added language in section 95830(c)(7) that requires account viewing agents to provide registration details to ARB seems unnecessary and onerous for individuals whose account access is already limited. By definition, an account viewing agent cannot transact, and can only review an account status. The level of detail required for registration in ARB's proposed amendments is not commensurate with an account viewing agent's responsibility.

Consider, also, that it may be common practice for multi-national companies to employ non-US residents as account viewing agents – employees who would not have US bank accounts.

D. Section 95834 (c)(2): Resubmittal of Know-Your-Customer Requirements

Section 95834(c)(2) adds a requirement that individuals registered in CITSS re-submit registration information every two years to enable the re-verification of documentation.

IETA appreciates the importance of adequate Know-Your-Customer requirements (KYC) for registration in the program, but questions the need for ARB to require that individuals re-submit this information every two years. The KYC requirements are already burdensome; a biannual re-submittal of that information (i.e. bank account information, addresses, photo identification) seems unnecessary and onerous. IETA recommends striking this proposed amendment, and retaining the language that ARB already has in place that would require re-submittal of information in the event that an individual's identity changes.

E. Section 95912 (d)(4)(E): Registration in Auctions

Section 95912(d)(4)(E) adds a provision requiring that an entity participating in an auction (including all associated entities) submit an attestation indicating that it has never been subject to any previous or ongoing investigation regarding "any alleged violation of any rule, regulation, or law associated with any commodity, securities, or financial market, including a change in the status of an ongoing investigation".

This is a significant divergence from the previous regulation language, which required just an "identification" of whether an entity had been involved in any investigation regarding the above-mentioned transgressions.

Is an entity unable to attest to such a statement denied from participating in an auction? If so, the language of the attestation seems unnecessarily harsh, not even taking into consideration whether guilt is proven during an ongoing investigation.

Further, the idea an entity should be denied participation in an auction due to the fact that even one employee within an organization with thousands of employees all over the world could have been found guilty of a violation at one point or another seems extreme.

IETA recommends that ARB revert to the original language from the current regulation as opposed to this proposed amendment.

4. TRANSACTION REPORTING REQUIREMENTS

ARB's rationale for proposing more detailed transaction reporting requirements, based on three different transaction types, is that doing so would provide ARB with more useful transaction data that could inform the marketplace.

IETA appreciates that ARB has listened to stakeholder feedback that the current one-size-fits-all approach to transaction reporting is not ideal, considering the different types of transactions that can occur. However, there are some further questions and concerns that IETA originally raised in our 2 August 2013 submission that we would like to point out again.

Generally, concern has been voiced amongst our membership that ARB may be wading into CFTC's jurisdiction in requiring that entities report on futures trades – particularly those falling under the third category of ARB's proposed list: "Exchange-Traded Contracts". Since CFTC already regulates these types of transactions, it seems redundant – and overly burdensome – that entities be required to report these transactions to ARB too.

A. Definitions

IETA appreciates the added clarity given to the definition of "Futures" in these latest amendments. However, there remains some confusion and inconsistency in the way that ARB refers to secondary and/or spot market transactions. A few examples follow:

- On page 53 of ARB's proposed amendments, the definition of "Spot" is a contract for the immediate delivery of and payment for a product. Yet in the breakdown of the three different transaction types (§95921(b)(2)), it appears that trades for delivery *within* 3 days could be considered spot, which might contradict ARB's definition of spot as "immediate delivery". Added clarity would be appreciated.
- Further to the previous point: it's possible that "futures" can be traded up to 3 days before delivery. Therefore, should such a trade be considered "spot" or "futures"? This confusion between "futures" and "spot" definitions makes the reporting requirement unclear in section 95921(b)(5)(C), which requests that entities "identify the contract as spot or futures".
- The definition of "over-the-counter" turns on whether the subject matter of the trade is listed on an exchange, not whether the trade takes place through an exchange. Since the third category relates to agreements for sale of compliance instruments through any contract arranged through an exchange or Board of Trade, the definition seems deficient. ARB should consider replacing the word "listed" with the words "executed or entered for clearing". The resulting definition would be: "Over-The-Counter means the trading of carbon compliance instruments, contracts, or other instruments not *executed or entered for clearing* on any exchange."

B. Section 95921(b)(1)(B): Counterparty Account Representative Confirmation

Section 95921(b)(1)(B) of the proposed amendments states that the seller of units in a transaction must need to know the "… identification of a primary account representative or alternative account representative for the destination account confirming the transfer request, if confirmation of the transfer request is required."

IETA members with significant experience in deliveries of cleared futures maintain that requiring such an additional test for a transfer will add unneeded complication. Specifically PARs and AARs at firms regularly change and it would not be common for counterparties to keep each other abreast of these personnel changes.

Should such a provision be implemented, several considerations follow. How quickly would CITSS be updated for personnel changes submitted by the buying party? Further, depending on how the test is implemented (e.g. drop down name selection vs. free form) and whether spelling of the names need to match exactly, transfer initiations may be delayed due to spelling errors. Finally, since all transfers of allowances that originate from trading must be confirmed by the buying PAR or AAR, what is the added value of having the seller input those names to initiate the transfer? Added clarification on these questions would be appreciated.

C. Section 95921(a)(3)(C): Time Frame for Transfers

The proposed language in this section makes it a violation to transfer compliance instruments on CITSS later than 3 days after the purchaser has paid for the transaction. IETA wonders why ARB feels the need to prescribe rules for this transaction process. We do not see why flexibility cannot lie with entities on this matter.

D. Section 95921(a)(4): Pre-Existing Transaction Agreements

The proposed language in this section states that "an entity may not submit a transfer request to another registered entity without an existing transaction agreement with that party authorizing a transfer."

IETA's membership believes this provision is unnecessary and problematic. Many registered entities are sophisticated parties that routinely operate in energy and commodity markets, and frequently close transactions based on oral agreement (generally recorded), instant message, or through other forms of communication. Such transactions may rely on a master agreement for additional terms and conditions, may rely on interpretation under the Uniform Commercial Code, and/or may rely on other legal principles, such as course of dealings between the parties.

IETA recommends that if such a provision is included, ARB should clarify that such an agreement need not be a formal written document.

E. Section 95921(b)(3)(B): Settlement Dates

This new section requires that a transfer request for an Over-The-Counter (OTC) agreement include a "date of settlement," and notes that, if there are financial or other terms to be settled after the transfer request is approved, the date those terms are to be settled should be entered as the settlement date.

IETA would like to point out that many terms to be settled may be subject to floating dates or dates triggered by other events. We recommend that if the settlement date is not fixed in the contract, ARB should allow an estimated settlement date to be provided without subjecting the reporting entity to liability if the date changes.

F. Section 95921(b)(4)(B): Transaction Agreement Termination Dates

This new section requires that a transfer request for an OTC agreement with delivery to take place in the future include a date upon which the transaction agreement terminates.

Similarly to the settlement date issue outlined above, termination dates are often not fixed, and the agreement may extend until all parties have fulfilled their obligations. IETA recommends that ARB include language clarifying that if the termination date is not fixed in the contract, an estimated termination date may be provided without subjecting the reporting entity to liability if the date changes.

5. COST CONTAINMENT

As stated in IETA's previous 2 August 2013 stakeholder submission, IETA supports ARB's proposal (as an initial first step) to make available 10% of future allowance budgets, as needed, at reserve sales once per year starting in 2015 at the highest price tier of the Allowance Price Containment Reserve (APCR).

This provision may provide some short-term relief in the case that prices rise unexpectedly. However, IETA does not believe that this provision adequately satisfies the Board Directive to prevent allowance prices from rising beyond the APCR, particularly in the case of an extended period of high demand due to unforeseen market dynamics or economic imbalances. Ultimately, it is in ARB and IETA's interest alike to ensure that prices do not rise so high that the Governor feels pressure to step in and exercise his/her right to suspend the cap-and-trade program.

IETA encourages ARB to re-visit the proposals originally discussed at the 25 June 2013 Public Workshop (including those by ARB, EMAC, and the Joint Utilities Group[2]), which explored a number of innovative options that would serve to keep prices below the highest-tier APCR price, while at the same time maintain environmental integrity.

We appreciate that some of these options would take much more work to determine how they could be implemented, both technically and legally. The timeframe with which ARB had to work with for this rule-making session may not be adequate to fully explore all the possibilities. However, IETA would be pleased to work with ARB to continue to explore the plausibility of going beyond this first proposed option to address cost containment.

In particular, IETA considers two options presented at the 25 June 2013 workshop to be worth further consideration:

[2] Joint Utilities Group Presentation: http://www.arb.ca.gov/cc/capandtrade/meetings/062513/industry-present.pdf

Offsets as Cost Containment

Expanding offset supply would be an effective means of containing the cost of the cap-and-trade program, while also ensuring environmental integrity of the program.

Additional low-cost compliance options could be introduced into the system through offsets in a variety of ways, but first and foremost is ensuring that offset supply meets demand. That can be done through the timely development and adoption of additional compliance offset protocols such as the Mine Methane Capture protocol currently being considered by the Board (more on this below).

Aside from the adoption of additional protocols, two relatively simple options to increase the effectiveness of offsets as a cost containment mechanism are: 1) expand entity compliance limits beyond 8%; or 2) allow entities to carry over unused offset limits from one compliance period to the next.

Sourcing Allowances from Third Party Greenhouse Gas Reduction Programs

If faced with an extreme case where keeping prices below the highest tier of the APCR was proving difficult, ARB could have a provision ready to kick in that allowed the creation of additional allowances to be sold at the highest tier price, providing crucial cost relief.

In order to maintain environmental integrity, the state of California could use revenue from the sale of these additional allowances to buy and then retire quantifiable and certified allowances from third party greenhouse gas reduction programs (such as the Regional Greenhouse Gas Initiative (RGGI)). Meaning that for each additional California Carbon Allowance (CCA) that ARB created and sold, a corresponding RGGI allowance would be retired. California could even choose to implement a quota system where for each additional CCA it created it would retire (for example) three RGGI allowances.

Not only would such a system provide cost relief and maintain environmental integrity, it would also serve to indirectly link its market to other markets – a goal outlined in AB32 to build regional and international markets.

Admittedly, developing such a provision would require much more research into various technical and legal procedures, but IETA encourages ARB to continue to explore the possibility. IETA would be pleased to work with ARB moving forward in this pursuit.

6. MINE METHANE CAPTURE OFFSET PROTOCOL

IETA strongly supports the proposed compliance offset protocol for mine methane capture projects, and appreciates the thorough stakeholder engagement process ARB held in the development of the protocol. Offset credits represent a crucial cost containment mechanism to help the California cap-and-trade program achieve GHG emission reductions in an economically efficient manner. IETA encourages officials to approve and make effective the protocol as soon as possible.

Generally, IETA supports ARB's efforts to develop new protocols that can provide offset credits to supply the market. In addition, we encourage ARB to update and expand existing protocols that can increase supply of already-proven, high-quality offset credits in the near-term.

CONCLUDING REMARKS

IETA appreciates the opportunity to record our comments related to ARB's Proposed Amendments to the California Cap-and-Trade Program and associated regulatory package including the proposed Mine Methane Capture Offset Protocol. Not only is IETA intent on helping to support a fully-functional California carbon market, we are also committed to helping achieve the goals of AB 32 to develop inter-jurisdictional and regional linked markets in order to realize environmental goals in an economically efficient manner.

If you have any questions, or further clarification is required, please do not hesitate to contact Robin Fraser (fraser@ieta.org) or Katie Sullivan (sullivan@ieta.org).

Sincerely,

Dirk Forrister
President and CEO