

January 11, 2010

Ms. Mary Nichols, Chairman
Mr. James Goldstene, Executive Officer
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: 3Degrees Comments on ARB Preliminary Draft Regulations for a California Cap-And-Trade Program under AB 32

Dear Chairman Nichols and Executive Officer Goldstene:

3Degrees appreciates the opportunity to provide comments on the Preliminary Draft Regulations for a California Cap-And-Trade Program, released on November 24, 2009.

3Degrees commends California on its leadership in developing regulations to reduce greenhouse gas emissions, and particularly commends the State for the recognition that a market-based system such as cap and trade would establish a cap covering about 85 percent of the State's GHG emissions and allow trading to ensure cost-effective emissions reductions. 3Degrees also commends the state for recognizing the role the high quality offsets from non-capped sectors can provide. We completely agree and support ARB's approach: offsets must meet rigorous criteria that demonstrate that the emissions reductions are real, permanent, verifiable, enforceable, and quantifiable. To be credited as an offset, the action or project must also be additional to what is required by law or regulation or would otherwise have occurred.

3Degrees is also encouraged that the State of California envisions linking its cap-and-trade program with other Western Climate Initiative (WCI) Partners to create a regional market system as well as potentially linking with national and international cap-and-trade systems.

From an industry perspective, it is essential to have regulatory certainty and consistency to effectively tackle the challenge presented by global climate change, lower the cost of compliance and increase global market liquidity for low-carbon technologies.

First 3Degrees offers some guiding principles to the design of California's cap-and-trade program followed by more specific detailed comments on the PDR later in the document.

1. Entities regulated under a California cap-and-trade program should have the ability to achieve their compliance obligations through the use of offset allowances from qualifying emission reduction projects.

Regulated entities should have the flexibility to help meet their compliance obligations by using emission reductions from projects that are not otherwise subject to the emissions cap. Multiple studies have shown that allowing use of such offset allowances can: (1) lower costs of compliance for regulated entities and costs of GHG regulation for society as a whole; (2) create greater incentives for development and deployment of emission reduction technologies; and (3) achieve emissions reductions from sources that would not otherwise occur.

2. Offset allowances should be available only for projects that achieve emission reductions that are additional, permanent, independently verified, enforceable, and measurable.

A California cap-and-trade program should include clear and rigorous rules for approval of projects and issuance of offset allowances. A credible authority should oversee administration of the offset program, with support from independent accredited third-party verifiers.

3. The project approval process should be transparent and rely on established, approved project types and methodologies, with clear procedures to approve new methodologies and project types.

The project approval process should achieve three objectives: (1) ensuring environmental integrity; (2) controlling administrative and transaction costs; and (3) providing for investment certainty as early as possible. Adoption of pre-approved methodologies and a preferred list of project types eligible for streamlined approvals will reduce compliance costs and investment risks, thus encouraging greater market participation. Similarly, a streamlined and transparent process for approval of new methodologies will provide necessary incentives for the development and deployment of new technologies.

4. Offset allowances should be available from an expansive set of sectors, activities, US states, and countries.

A California emissions reduction program should focus on environmental integrity of projects and their compliance with the relevant standards created by the program. All project types that are not otherwise subject to emissions limits and that can comply with the applicable standards should be eligible.

5. A California GHG regulatory program should allow for the use of offset allowances from international projects.

Climate change is a global environmental issue. As such, geographic location should not limit the ability of a project to qualify under a GHG regulatory program. Indeed, many low cost opportunities for reducing emissions are in developing countries. Accordingly, allowing for the use of reductions from such countries not only will lower the costs of compliance with the California program, it will provide a means of transferring U.S. clean energy technologies and expertise to the developing world and (many of these technology companies are based or operate in California.

6. Entities that implement emission reduction projects prior to the establishment of a California cap-and-trade program, and that meet the applicable standards for project eligibility, should be awarded offset credits.

Entities (not just those subject to emissions limits) that implement otherwise-qualifying projects should be provided offset credits for reductions achieved by those projects prior to establishment of the ARB cap on GHG emissions.

3Degrees respectfully submits the following comments on specific provisions of the Preliminary Draft Regulation for a California Cap-And-Trade Program.

1) Voluntary Renewable Market Post 2012 (Sec 95910)

- **3Degrees is a founding member of the Renewable Energy Markets Association (REMA), and strongly supports the extensive comments submitted by REMA on the ARB proposal for *Adjustments to the Base Budgets to Account for Voluntary Investment in Renewable Sources of Electricity Generation*.**

3Degrees is a leading provider of Green-e Energy certified Renewable Energy Certificates in the voluntary market and strongly applauds ARB's inclusion of the provision for *Adjustments to the Base Budgets to Account for Voluntary Investment in Renewable Sources of Electricity Generation*. There should be no cap on the administrative adjustment. The rationale for a cap on the administrative adjustment is usually to protect emitters from having to acquire scarcer (and possibly more expensive) allowances. However, every renewable MWh generated to the grid reduces the number of MWh (and emissions) generated from other sources, thereby reducing the need for allowances. When both supply of and demand for allowances are reduced by an equal amount, the price of allowances should be unaffected.

2) ARB Offsets Program (Subarticle 13)

- **3Degrees strongly encourages ARB to finalize rules on the eligibility of specific offset project types, offset protocols, and the approval process for ARB-approved offsets.**
- **Creating market certainty will generate demand for offset projects and enable early investments to occur.**

Offsets play an important role in deploying clean energy and low-carbon technologies, reducing greenhouse gas emissions and reducing the cost of the program. 3Degrees supports linking the California cap-and-trade program to other programs.

3) Role of ARB in Offset Market (Subarticle 13)

- **ARB's dual role should be to approve offset credits issued by external programs to create near term offset supply and for ARB to become an offset credit issuing body in the medium-term as well.**
- **ARB should establish a stream-lined approval process for conversion of Climate Action Reserve-issued Carbon Reduction Tons (CRTs) into ARB-issued offset credits.**
- **Approving offsets issued by external programs that meet rigorous quality standards will help meet the near-term demand for offset credits offering California a "best of both" worlds solution.**

Rather than duplicating the work of CAR, ARB should scrutinize the CRTs issued by CAR to ensure they meet ARB standards. 3Degrees recommends that ARB adopt both roles provided that the offsets meet the stated environmental integrity criteria of ARB: real, permanent, verifiable, enforceable, quantifiable, and additional to what is required by law or regulation or would otherwise have occurred. This hybrid approach is practical. In the medium-long-term

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ARB will want to develop the capacity to become an offset issuing body. In the short-term this is unlikely to occur resulting in severe shortage of offset credit availability when the cap-and-trade program goes live in 2012. ARB should establish a process to:

- Convert CAR-issued CRTs into ARB-issued offsets for the vintages 2007-2020; and
- ARB should establish a realistic date-certain when ARB will assume the role of a full functioning offset issuing body for new projects applying for offset crediting.

4) Offset Project Start Date (Subarticle 13)

- **All CAR-registered offset projects, including ones commenced prior to 12/31/06, that meet all applicable ARB standards should have their CAR-issued CRTs converted into ARB-registered offsets.**
- **In addition, ARB should adopt a project start date of 12/31/03 or later provided ARB's rigorous standards are met.**

The choice of project start date is too often chosen for optical considerations as opposed to technical/scientific ones. 12/31/06 or later could preclude legitimate offset projects that commenced prior to this date in anticipation of a future carbon market from participating in California's AB 32 market. Several CAR-registered offset projects using ARB-approved offset methodologies fall into this category. Keep in mind the degree of risk and uncertainty an emission reduction project faces when it commences and the length of time involved in the offset project registration cycle. 2008 was the first year in which CAR began registering and issuing CRTs for vintages from 2006 and forward including some projects that commenced prior to 2006. In these early cases projects were serving as pioneering efforts to create a carbon market as were the early steps of CAR to build the quality assurance infrastructure for a nascent and emerging carbon market.

5) Offset Banking (Sec 96090)

- **3Degrees agrees with ARB that allowing banking of allowances creates incentives for covered entities to make early reductions since the declining cap could push allowance prices higher over time.**

6) Quantitative Usage Limit on Offsets and Carry-Over of Allowable Offset Usage (Sec 95970)

- **Quantitative limits on the use of offsets should be avoided in favor of rigorous standards for environmental integrity.**
- **If a covered entity elects not to surrender offsets equal to 4% of their surrender obligation in a given compliance period they should retain the ability to carry-over to future compliance periods the equivalent proportion of offset usage as part of their subsequent surrender obligation.**

The introduction of artificial limits only invites market distortion and limits the flexibility of the emissions reductions program, unnecessarily increasing overall compliance costs. Stringent

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standards will ensure that only additional, high-quality offsets can be used for compliance. High standards will in turn provide a natural limit on the total number of offsets allowed, as a result of market forces.

The existing quantitative limits as outlined in the PDR should not be pushed back any further. 3Degrees opposes quantitative offset limits in theory, but understands the importance of using offsets as a tool to supplement emission reductions occurring at the source of a capped entity. We also understand limiting offsets out of the necessity to gather broad stakeholder acceptance for a cap-and-trade program.

However, California's Scoping Plan has already imposed significant quantitative limits by restricting offsets to 49% of the overall reductions required in the program, and this number should not be pushed back any further. The PDR restricts offsets to 4% of what a covered entity must submit at the end of each compliance period (equivalent to 49% of all reductions but enforced on a per entity basis). Without the ability to have carry over the Quantitative Usage Limit on Offsets could create market distortions and ensure that less than 49% of overall reductions come from offsets, which clearly is not ARB's stated intent.

California's proposed offset limits are more restrictive than what is likely to be enacted in legislation at the federal level. Under the Waxman-Markey bill, approximately 30% offsets are allowed (as a percent of the overall emissions budget in the program), half domestic and half international, and this percentage increases towards the later years of the program. The US Climate Action Partnership (USCAP), broadly recognized as one of the most important coalitions on climate change policy in the US, and which brings together members from some of America's largest corporations and NGOs, has supported a robust federal offsets program with a 2 billion offset pool—1 billion each of domestic and international.

If the allowable pool of offsets in California is too small, there will be little incentive to build capacity to access it, and capital will flow elsewhere. 3Degrees would encourage California to expand the allowable use of offsets in the State. At the very least, existing limitations should be held strong and not pushed back further. Carry-over is critical.

7) ARB Should Approve an Early Positive List of Approved Offset Protocols (Subarticle 13)

- **Having an early “positive list” of approved methodologies by October 21, 2010 when ARB is scheduled to finalize the cap-and-trade regulation would be an enormously important and helpful step towards a functioning California AB 32 offset market.**
- **California could adopt other existing protocols and offset systems to enable an early supply of offsets to meet the demand created by the beginning of AB 32 compliance in 2012.**

The PDR states that “Due to potential future updates in scientific data and quantification methods, the offset quantification methodologies themselves will not be written into the cap-and-trade regulation. The regulation will set out the process by which the Board can approve and amend offset quantification methodologies based on criteria spelled out in the regulation...” The PDR goes on to state that ARB will consider new offset quantification methods on an annual basis.

3Degrees understands that ARB needs to establish a rigorous and deliberative diligence process for reviewing and approving offset protocols including public stakeholder review, but when the Cap and Trade Regulation is approved by ARB in October 2010, it would mean that only the process is approved without any certainty as to which if any offset protocols are approved. This would mean it would be at least 1-2 years from the time of the cap and trade rule approval before the 1st set of California approved offset protocols is known. That would lead to a great amount of market uncertainty.

Since ARB has already approved 5 specific CAR offset quantification methodologies since 2007 as “voluntary GHG reduction protocols”, it would be an important signal to the market if ARB would formally adopt the final set of rules for compliance offset approval for these 5 CAR protocols.

8) Trading and Banking; and Regulation of OTC Transactions (Sec 96080)

- **Opt-in Registrants – 3Degrees appreciates that ARB recognizes the role that non-covered entities such as developers, brokers, traders, and marketing entities play in the GHG cap-and-trade market.**

- **Holding Limits – Holding limits be established in such a way that they do not intentionally or arbitrarily shut some market participants out of participating in the market.**

- 3Degrees recognizes that reasonable holding limits are customary in commodity trading markets.
- Size of market participants matters greatly in regard to how holding limits are set. RGGI has set some reasonable holding limit rules that ARB can study.
- Margin and net capital requirement should be reasonable and sensitive to the different sizes and roles of market participants to ensure a level playing field.

- **Trading Facilities for Bi-lateral Contracts and Non-Exchange Traded Derivatives – Many OTC transactions are non-standardized and customized to fit individual market participants hedging needs. Thus, ARB should not overly restrict the ability of over-the-counter (OTC) transactions to occur.**

These types of OTC transactions serve a legitimate role that is not adequately addressed through standardized products alone. For example parties may wish to engage in longer term transactions for which there is no available exchange traded product.

- **Clearing Facilities for Bilateral Trades of Offsets – There will almost always be a need for non-exchange traded OTC transactions and ARB rule should leave room for this type of customized transaction.** ARB has proposed that bi-lateral trades of offset contracts be cleared through a commercial mechanism to maintain documentation until standardized contracts are developed suitable for exchange trading. 3Degrees understands the value of clearing bi-lateral contracts through a clearing mechanism, but as stated above non-standardized OTC transactions should not be pre-empted.

9) Remedies for offset reversals and for offset deficiency (Sec 96390)

- **ARB should establish an offset program that is sufficiently rigorous that ARB will stand behind the credits it issues as approved compliance instruments, otherwise the offset market will be fraught with uncertainty.**
- **Reversal of emission reduction credits is best remedied through buffer pools and insurance products.**
- **It seems as if ARB is lumping the concepts of offset reversal and offset deficiency in the same bucket, but as we see it they are very different events.**

ARB is recommending that the covered entity submitting offsets that are found on review to be deficient be held responsible for replacing them. All offset project types are subject to the risk of being found deficient, i.e. not meeting the quality standards established for offset quantification, verification and issuance, but this determination must be made prior to issuance, not after. If an offset project is deficient it could be rejected at any number of stages from validation, to registration, to verification and finally at issuance. If issued offset credits are not deemed to be sufficient for surrender as a compliance instrument then this calls into question the rigor of the entire process. The only exception is the case of offset reversal which is a completely different event and addressed next.

Some offset project types such as GHG sequestration and avoidance projects are subject to the risk of reversal, also known as risk of non-permanence. Some offset projects such as emission reductions are usually not subject to the risk of reversal. For example a landfill gas destruction project permanently destroys fugitive methane emissions. Once emissions are destroyed they can never return to the atmosphere. Avoidance and sequestration projects that involve GHG removals and storage do face the risk of reversal. For example a forestry project that removes and stores GHG could subsequently release the stored GHG back into the atmosphere as a result of a catastrophic fire or pest infestation. This is rare, but could happen.

Remedies are available for addressing the reversal of issued offset credits after their use and surrender by a covered entity as a compliance instrument. We have concerns with ARB's proposal that covered entities be responsible for replacing reversed tons. ARB suggests that this would be accomplished by "make whole" contracts between offset providers and covered entities. This in fact would create credit risks for offset providers of a massive scale that would lead to huge inefficiencies and uncertainties.

Mitigating risk of offset non-permanence through use of buffer reserves and/or insurance products is a much more efficient remedy. For example project owners of forestry projects registered in CAR are required to contribute to CAR-administered Buffer Pool to provide insurance against reversals of GHG reductions and removals due to unavoidable causes (including natural disturbances such as fires, pest infestations, or disease outbreaks). A project risk rating determines the quantity of Climate Reserve Tones (CRTs) that the project must contribute to the Reserve Buffer Pool to insure against reversals.¹ Another variation on the reserve buffer

¹ For a detailed discussion on how the CAR Buffer Pool works see *CAR Forest Project Protocol Version 3.0, September 2009*, endorsed by ARB on September 24, 2009.

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pool is a collective reserve administered by the offset registry where the issuing body required each sequestration project to contribute verified credits into a central buffer pool that is held in reserve for reversal remedies. This later approach is used by the Voluntary Carbon Standard as well.

10) Cost Containment (Sec 96040)

- **A well designed Strategic Allowance Reserve combined with a “soft collar” which includes predictable escalating Allowance Floor Prices and predictable escalating “minimum strategic reserve auction prices” minimizes uncertainty and avoids market volatility.**

3Degrees appreciates that ARB has assembled a range of thoughtful options on cost containment mechanisms which is an important consideration. Above all, we are glad that ARB clearly considers cost containment in a sophisticated and progressive way and has identified three key issues:

- Any attempt at price mitigation could limit price discovery and adjustment which are main benefits of a cap-and-trade program.
- The mechanism must respect the integrity of the cap by not including a “safety valve.”
- The options may require changes in the PDR on offset quantitative limits, offset quality, and linking.

We agree with the first two points and we agree that increasing the offset pool can be one mechanism to mitigate costs, but we strongly believe that any increase in the offset pool should not be at the expense of offset quality. ARB should maintain consistent offset standards and increasing the pool is not incompatible with that goal.

A Strategic Reserve is a sound cost-containment mechanism that is worth supporting particularly because it avoids hard price caps which are antithetical to a market based cap and trade system working effectively. We support the “soft price collar” that combines an escalating Allowance Floor Price and an escalating “minimum strategic reserve auction price”. This provides a predictable minimum strategic reserve auction price and avoids market volatility. A well defined soft price collar minimizes uncertainty, whereas hard price collars introduce market distortions which can undermine the efficient function of a cap and trade system.

When the strategic reserve is depleted through auctions emissions of covered entities are allowed to rise, but they can be counter-balanced by additional reductions achieved elsewhere through replenishing the reserve with high quality offsets. Proceeds from the auction should be used to purchase additional offsets to refill the reserve.

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About 3Degrees

3Degrees, based in San Francisco, is a recognized market leader in renewable energy and climate mitigation products and services. The award-winning firm offers retail and wholesale marketing of Renewable Energy Certificates and Verified Emission Reductions (also known as carbon offsets), climate and energy strategy consulting, marketing and communications services, utility green power program partnership services, and regulatory expertise.

Through these and other partnerships, 3Degrees has supported over 375 high-quality renewable energy and carbon reduction projects in California and throughout the United States. Our commitment to these projects creates jobs and stimulates the low-carbon economy. In addition, this September 3Degrees was named “Renewable Energy Marketer of the Year” by the U.S. Department of Energy for the fourth time in five years.

3Degrees has been working consistently with state, federal and international policymakers on market-based measures to reduce greenhouse gas emissions since its inception in 2002. 3Degrees executed the first transfer on the Gold Standard Foundation’s VER registry in 2008. 3Degrees purchased CRTs from the first Climate Action Reserve (CAR) registered project in 2007.

Conclusion

3Degrees greatly appreciates the hard work and leadership that ARB staff has put into the PDR and overall AB 32 program. The PDR is the most detailed proposal to date from ARB on cap-and-trade and we are thankful for the thoughtfulness of the proposal and appreciate the opportunity to contribute comments to the process.

Sincerely,



Gabe Petlin
Director of Regulatory Affairs