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Clerk of the Board
California Air Resources Board
1001 I Street
Sacramento, California 95814

IETA COMMENTS ON LINKING CALIFORNIA AND QUEBEC'S CAP-AND-TRADE PROGRAMS

On behalf of the International Emissions Trading Association (IETA), I am grateful for the opportunity to provide comments, in response to California Air Resource Board's "Public Workshop to Discuss Linking the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation to Western Climate Initiative (WCI) Jurisdictions." I hope that ARB considers IETA's perspectives and insights as it moves forward with the linking process.

IETA extends its appreciation to California for beginning the process to link its cap-and-trade program with Quebec's. The aim of the WCI is to take cooperative actions to address climate change, and linking programs is a critical component of achieving this goal. Linking provides an opportunity for a more robust allowance market to emerge across jurisdictions. Importantly, linking reduces the overall combined costs of the programs by broadening the scope of available mitigation opportunities and further sparking competition to innovate and mitigate. In short, linking could lead to more effective price discovery. Additionally, linking increases market liquidity and reduces transaction costs by involving more market participants, thereby decreasing the potential for market manipulation. A carefully designed and well-executed linkage of these programs, which builds off valuable experiences and lessons learned from other environmental markets, will help maximize these improvements as well as maintain California's growing international reputation as a climate policy leader.

INTRODUCTION

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 160 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.

For over a decade, IETA has remained committed to its vision of a global greenhouse gas market. To this end, IETA has facilitated thought leadership on linking through its original research. In 2007, in preparation for COP 13 in Bali, IETA commissioned Judson Jaffe (formerly Vice President of the Analysis Group) and Dr. Robert Stavins (Harvard University) to write the first comprehensive report on linking.[1] Since this report, IETA has continued to view linking as a critical component of

[1] Analysis Group "Linking Tradable Permit Systems for Greenhouse Gas Emissions: Opportunities, Implications, and Challenges" November 2007

creating a consistent, fair and cost-effective international framework for reducing greenhouse gases.

OVERVIEW OF KEY RECOMMENDATIONS

A linked California-Quebec carbon market has the potential to reduce overall combined costs, increase liquidity and assuage concerns about market manipulation. However, proper implementation of a linked market is required to avoid negation of the benefits. In order for a linked market to fully realize these potential benefits, IETA believes that two main prerequisites must be satisfied. First, policies that are absolutely critical to successful linking must be harmonized. Second, in harmonizing differences between California's and Quebec's policies, a set of policies that maximizes compliance flexibility and market liquidity should be chosen. Additionally, IETA believes the impact of linking on holding limits requires a reconsideration of this policy.

Identification of Policies that Critically Require Harmonization for Linking

IETA has identified two critical policies that absolutely must be harmonized to result in successful linking: auctions and compliance requirements. Monitoring, reporting and verification (MRV) standards must also be consistent enough so that purchasers of allowances can be assured California and Quebec allowances represent the same quantity of reductions—that "a ton is a ton." Without this basic level of consistency, fungibility cannot be established between California and Quebec allowances and trading will be stunted. Regarding auctions, IETA believes the long-term goal for ARB should be a joint auction. Compared to a separate, but coordinated auction, joint auctions have the potential to create more liquidity and better achieve economies of scale. However, without a minimum of harmonizing critical policies, IETA cautions ARB against rushing a joint auction. Generally, IETA identifies the following auction features that ARB should prioritize in its linking efforts: exchange rates and auction denominations, price floors and floor growth rates, and timing of reserve auctions. Additionally, IETA recommends harmonizing annual compliance obligations and the timing of compliance deadlines.

Identification of Important Policy Differences between California and Quebec

IETA understands that ARB is considering harmonizing policies in addition to those IETA has deemed critical. While the benefits of harmonization must be considered on a case-to-case basis, IETA strongly believes that the harmonization of policies should not come at the expense of compliance flexibility. Furthermore, IETA cautions that further harmonizing policies could complicate, and possibly prevent, future linking with other jurisdictions. Generally, IETA recommends that each jurisdiction adopt the most flexible of their combined options for certain policies and mechanisms. This strategy will result in a more efficient and competitive market that yields lower allowance prices. IETA identifies important differences between California and Quebec regulations regarding these policies: auction purchase limits, corporate association and allowance allocation. IETA prefers harmonization that moves towards the most flexible policy of the jurisdictions.

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1730 Rhode Island Ave. NW, Suite 802
Washington, DC 20036
+ 1 (202) 629-5980

Reconsidering Holding Limits

Given the current design of holding limits, IETA is concerned that linking would create opportunities for market manipulation and actually damage market efficiency. While IETA acknowledges that linking will increase holding limits, it is important to note that the change is not proportional between California and Quebec; the magnitude of change in holding limits for Canadian entities will be much larger than the change for California entities. This resurrects IETA's previous concern regarding market manipulation. Specifically, the use of holding limits has the unintended consequence of advantaging entities with a small compliance obligation relative to entities with large compliance obligations. Companies with a large compliance obligation will require more annual allowances than the purchase limit at a quarterly auction. This will likely increase the potential for price manipulation and price volatility by limiting a company's ability to sit an auction out if prices are excessively high in that particular auction. In addition, such companies would have limited ability to buy allowances to sell in the secondary market, which would put these companies at a disadvantage to companies with a smaller compliance obligation. IETA is concerned that the disproportionate change in the size of holding limits might further, and unfairly, disadvantage larger covered entities. The overall result could be a deviation from a competitive, efficient market that produces least-cost allowance prices.

A recent report from the Legislative Analyst's Office (LAO), entitled "Evaluating the Policy Trade-Offs in ARB's Cap-and-Trade Program," largely echoes IETA's concerns on holding limits. IETA believes the report correctly characterizes holding limits as "somewhat arbitrary and inflexible" and appreciates that the authors make the point that "…the risk of carbon market manipulation may be overstated. Other types of markets involving the trading of commodities function well without holding limits."

In line with the suggestions from the authors of the LAO report, IETA recommends ARB consider eliminating holding limits. As an alternative, at minimum, IETA suggests that ARB tie holding limits to an entity's emissions exposure.

RECOMMENDATIONS FOR HARMONIZING POLICIES CRUCIAL TO SUCCESSFUL LINKING

A. Harmonizing Auction Features

In preparing its recommendations for auctions, IETA has been able to draw on its experience with auctions in the European Emissions Trading Scheme (EUETS). IETA looks forward to facilitating the transfer of knowledge between California and Europe and would be eager to respond to any requests for information ARB may have regarding the EU ETS, or other international trading programs. Where appropriate, IETA distinguishes between its recommendations for auctions based on whether or not they are to be held in one or two currencies.

Exchange Rates

Commodity markets function well without governments fixing exchange rates. Companies can hedge against exchange rate fluctuations and do so on a daily basis for all international commercial transactions. Accordingly, IETA believes market participants can seamlessly incorporate a flexible rate into their purchasing strategy for emissions allowances. For example, allowance auctions in

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Washington, DC 20036
+ 1 (202) 629-5980

Europe are already undertaken in different currencies (mainly GBP and EUR) and this has not created problems for companies covered by the EU's Emissions Trading Scheme, which spans 30 countries with 13 different currencies. However, certain auction features unique to a California-Quebec carbon market necessitate some qualifications. If auctions are held in two currencies, IETA recommends that the exchange rate is set before the auction to provide clarity to auction participants. Importantly, this would ensure consistent price floors and reserves (ceilings) between the two systems. Also, this would prevent scenarios where different guesses of the exchange rate produce inefficient outcomes. For example, if an auctioneer accepts bids in both USD and CAD, and a Canadian entity bids C$11, which at the time of the bid was worth US$11.10, but then the auctioneer uses an exchange rate to determine that bid was only worth US$10.90, the Canadian entity has overpaid, simply because its expectations didn't perfectly align with the auctioneers. In the case that auctions are held in a single currency, IETA retains its stance that flexible exchange rates are superior.

Harmonizing Auction Purchase Limits

IETA recommends harmonization to ARB's rules regarding purchase limits, as they will provide for more compliance flexibility and market liquidity than Quebec's rules. Currently, Quebec has a 15% limit on vintage year 2013 and 2014 allowances, as well as a 25% limit on allowance vintages 2015 and beyond. In contrast, California has a 15% limit on current vintage year allowances with a 25% on future vintage year allowances. Ideally, IETA prefers that there is no limit on auction purchases.

Harmonizing Price Floors

Both California and Quebec regulations have price floors that rise at 5% plus inflation, but these regulations differ in base year prices and inflation indicators. While both programs have a $10 price floor, Quebec's floor price starts growing at 2013 while California's floor price starts growing at 2014. IETA recommends Quebec harmonize to California's auction policy.

B. Harmonizing Compliance Requirements

IETA recommends that ARB harmonize differences in compliance obligations and deadlines. Currently, significant differences exist between California and Quebec policies that, if rectified, would provide additional certainty and liquidity to the market. Currently, Quebec has no annual compliance obligation and a compliance deadline in October while California has a 30% annual compliance obligation (with a true-up at the end of a compliance period) and a compliance deadline in November. IETA looks forward to working with ARB to identify how to harmonize these policies.

RECOMMENDATIONS FOR ADOPTING POLICIES THAT MAXIMIZE COMPLIANCE FLEXIBILITY

In addition to identifying areas where harmonization is a prerequisite for linking, IETA wants to ensure that compliance flexibility is not compromised by the adoption of certain policies. The great opportunity that linking provides is for more flexibility. Through linking markets, governments grant covered entities an opportunity to shop for allowances in other jurisdictions; the more options that are available the more robust, liquid and efficient the market becomes. The results are lower prices and less volatility.

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A. Corporate Association

IETA also expresses concerns with Quebec's rules regarding corporate association. In order to deliver the full benefits of the market for consumers, a linked program needs to encourage participation not just from covered entities but also from other liquidity providers, such as financial institutions. Currently, Quebec's regulations require association and disclosure at 20% common ownership and California's regulations require disclosure at 25% and association at 50%. IETA recommends adopting ARB's rules regarding association in order to increase market liquidity and, thereby, facilitate price discovery and cost containment.

B. Allowance Revocation Authority

Currently, Quebec's allowance allocation regulations contain a provision that California's regulations do not. Specifically, Quebec's regulations include a provision allowing regulators to re-evaluate original free allocation estimates. If the initial free allowance allocation in a given year proves to under-or over-estimate a facility's actual emissions once retroactively verified, regulators can make additions or subtractions to previous years' vintages in order to "true up" the allocation count. This provision could introduce supply risk and hamper market liquidity due to chance that allocated permits could be rescinded. However, the provision does assure facilities that they will be allotted the correct amount of allowances based on their actual emissions, and that their allocation will not be underestimated. IETA recommends ARB remain aware of this difference as it moves forward with its linking process.

ADDITIONAL OBSERVATIONS

A. Offsets Should be Fungible and Numerous

IETA believes current ARB policies will seriously hamper the offsets market. Again, IETA welcomes the recent report from LAO, which expressed concern regarding the current ARB offsets' invalidation provisions that hold buyers liable should ARB choose to invalidate an offset. Accordingly, IETA recommends that ARB eliminate these invalidation provisions.

IETA suggests that ARB accept all environmentally rigorous offsets—as Quebec releases offset protocols—and early action credits from Quebec – just as it would suggest to Quebec to accept any such offsets issued by ARB for California. The number of offset protocols should be aggressively increased to remedy the predicted gap in supply. In order to ensure the fungibility of these credits, Quebec and California offset protocols, Quebec's early action reduction credits and California's early action offsets should all be of similar stringency. ARB's acceptance of these compliance instruments will stimulate offset supply, increase flexibility and reduce overall program costs significantly.

B. ARB Should Continue Seeking Linkages with Other Partners

Lastly, IETA recommends making further efforts to provide linkages with markets outside of the WCI. Such linkages would not require the creation of a joint program, but simply ARB-recognition of allowances (for example, allowances from the EUETS). The linking process would be therefore greatly simplified yet still create an opportunity for further cost savings.

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CONCLUDING REMARKS

IETA extends its appreciation to ARB for their efforts to develop a fully-functional, linked, international greenhouse gas market to achieve California's ambitious environmental goals. Through appropriate harmonization and consideration of flexibility and market efficiency – and transparent stakeholder communication on linking design options – IETA believes that a joint California-Quebec carbon market will reinforce California's growing international reputation as a leader in innovate climate policy.

On behalf of IETA and our member companies, IETA would like to thank you for providing this opportunity to comment on ARB's *Public Workshop to Discuss Linking the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation to Western Climate Initiative Jurisdictions* as well as for your attention to these comments.

We stand ready to answer any questions regarding our submission, and we look forward to working with California and Quebec officials to help inform their linkage design and implementation process. Please do not hesitate to contact Clayton Munnings (munnings@ieta.org) if you have any questions.

Sincerely,

Henry Derwent

Henry Derwent
President and CEO