

The Honorable Mary Nichols
Chairman
California Environmental Protection Agency
Air Resources Board
1001 I Street
Sacramento, CA 95812

RE: Evolution Markets Comments to the Air Resources Board Regarding Offset Protocols

July 09, 2010

Dear Chairman Nichols:

Evolution Markets Inc. (“Evolution Markets”) commends the California Air Resources Board (“ARB”) on its continued progress toward the implementation of Assembly Bill 32 (“AB 32”), and we welcome the opportunity to provide comments on the design of an offsets system in a California Cap-and-Trade Program.

Evolution Markets is a leading financial services firm providing professional brokerage, structured transaction, and merchant banking services to participants in the global environmental markets. Our Carbon Markets Brokerage Group is among the industry’s largest, and through our offices in San Francisco, New York, London, and Beijing, we have been active in facilitating many of the global carbon market’s pioneering transactions.

Principals at Evolution Markets have participated in market design with various international, regional and state authorities as many of the global carbon markets underwent their formative stages. Evolution Markets’ principals also have more than ten years experience facilitating emissions reduction credit (ERC) transactions in California’s various air districts, as well as trades under the South Coast’s RECLAIM program. As such, Evolution Markets has been a consistent advocate for market-based approaches to reducing emissions. Our belief is that cap-and-trade programs can be an effective tool for achieving environmental goals at the lowest possible cost.

While we believe California consumers can see cost-containment benefits from the carbon offsets program proposed by the ARB, the offsets market must be designed in such a manner to achieve these ends. Below we offer suggestions relating to the development of offset protocols. As you continue to promulgate rules for such a program, Evolution Markets appreciates your consideration of the following recommendations.

I. Introduction

Evolution Markets acknowledges the ARB must incorporate offset protocol form information, as well as offset verification and enforcement rules into regulation pursuant to AB 32. We acknowledge and strongly support that compliance-grade offsets in a California cap and trade program must strictly

and objectively meet the criteria outlined in AB 32 and the Preliminary Draft Regulation (“PDR”) as being real, additional, quantifiable, permanent, verifiable and enforceable. Lastly, we strongly agree it is imperative to preserve the environmental integrity of offsets in a California cap and trade program 1) for the benefit of the environment, and 2) for the long term political viability of the program and the nascent marketplace for environmentally and socially beneficial financial products.

As an innovator in environmental finance and the design of environmental markets for over 10 years, Evolution Markets offers the following comments to the ARB:

II. Recommendations on Transitioning Protocols

Evolution Markets suggest the ARB minimize, or to the extent possible, fully avoid any changes to the Climate Action Reserve (the “Reserve” or “CAR”) Livestock, domestic Ozone Depleting Substances (“ODS”) and Forestry project protocols. Evolution Markets believes these protocols have been developed through a robust public stakeholder process, in some cases with the ARB providing significant input. To the extent ARB does move forward with changes to the Reserve protocols, the ARB should clearly identify the required steps market participants must follow to bring existing and future projects into compliance with AB 32.

A. General

- 1. Prioritize linkage with the Reserve.** Evolution Markets believes that the ARB should focus its limited time and resources on transitioning the existing supply of Climate Reserve Tonnes (“CRTs”) into the cap and trade program by prioritizing linkage with the Reserve **at the same time** as developing the ARB offset protocols. We strongly urge the ARB to define a clear process, including linkage timing, identification of specific CRTs useable to meet compliance obligations, including guidance on project type, vintage and start date. We also urge the ARB to state how the CRTs may be used for compliance (i.e. 1:1, bankability, etc.). Lastly, we encourage the ARB to outline any additional steps that will be needed to make a CRT “compliance-grade”, such as additional verification requirements. Based on our experience negotiating transactions in the domestic “pre-compliance” markets for offsets, market participants require this specific information to continue investing in emission reductions and to better manage risk capital associated with existing investments in the market.
- 2. Distinguish between CRTs and ARB-certified offsets as they relate to meeting compliance obligations.** Evolution Markets believes the concept of “transitioning” CAR protocols is confusing to market participants and is ultimately creating unnecessary uncertainty and inaction in the marketplace, ultimately delaying investment in current and future GHG reductions and discouraging early action. Evolution Markets recommends that the ARB: a) make clear and definitive their intention to link with the Reserve to accept CRTs for compliance, providing the information above, *and* b) concurrently generate separate, distinct ARB protocols that will issue ARB-certified offsets. This will foster confidence in existing CRT investments and will allow

participants to make investment decisions between CRTs or to wait to invest in ARB protocol projects. The market will assign any pricing disparity, if any, between the two distinct offsets however, knowing both will be compliance-grade will foster early action rather than inaction.

- 3. Define additional steps to certifying CRTs for compliance.** As stated above, Evolution Markets recommends the ARB link with CAR and credit CRTs for early action. However, should the ARB not find this approach feasible, we recommend clearing defining for the market additional steps to certifying CRTs for compliance. Evolution Markets encourages the ARB to define a clear, transparent process market participants will follow to make CRTs “compliance-grade.” It is clear a CRT, as it stands now, will not meet the strict regulatory requirements of AB 32. However, it is unclear to the market what exactly a participant must do to transition their CRTs into the ARB program. Evolution Markets recommends the ARB define exactly what would need to happen to make a CRT compliant with the requirements outlined in AB 32 for offsets. This will enable the participants to quantify any additional cost or risk of owning a CRT vs. an ARB-certified offset.
- 4. Use a benchmark for regulatory additionality consistent with the ARB’s working definition of additionality.** The ARB is contemplating defining and applying a regulatory benchmark to measure the additionality of offsets in the cap and trade system. Evolution Markets understands based on the workshops that the ARB is considering this approach in order to protect California regulatory provisions and offsets. Evolution Markets believes that California should apply a regulatory additionality benchmark that is consistent with the ARB’s definition of additionality,

“GHG emissions reductions or removals that exceed any GHG reductions or removals otherwise required by law or regulation, or any GHG reductions or removals that would otherwise occur in a conservative business-as-usual scenario.”

In the definition ARB refers to “reduction or removals otherwise required by law or regulation,” but makes no distinction based upon jurisdictional law or regulation. The Early Discreet Action for landfills under AB 32 will require most landfills **within** the state of California to manage emissions. However, the national standard, the New Source Performance Standard (“NSPS”), is the benchmark established for emissions at landfills across the United States. Evolution Markets recommends that a benchmark of regulatory additionality for purposes of AB 32 should use the applicable law relevant to the given jurisdiction as the “*law or regulation*” that determines the additionality of any given offset. Application of California-specific regulatory thresholds will exclude a legitimate supply of early action offsets from the market, which could increase compliance costs early in a California cap and trade program.

- 5. Crediting period and eligible start date.** Evolution Markets recommends a crediting period for non-sequestration projects consistent with the length of the cap and trade program, so long as

the project is annually certified to be compliant with the most recent project protocol and all strict criteria for additionality. Evolution Markets agrees with a crediting period of 10-30 years with unlimited renewals – as long as the project meets program criteria for sequestration projects. Using a performance-based approach to additionality will lead to incremental modifications in thresholds for additionality as regulation evolves. Certification that the project meets the latest protocol and additionality requirements should require third party verification and a legal attestation from the firm’s senior management. Cap and trade will create long-term liabilities for firms that emit greenhouse gas emissions. So long as offsets meet strict project and additionality criteria, incentives should be maintained to both support long-term investment in emission reductions and long-term ability to hedge emission liabilities via crediting surviving the program length.

Evolution Markets recommends that the project eligibility start date be consistent with the Western Climate Initiative (“WCI”). Regarding project eligibility start dates, we believe that those firms that took risk and action early to achieve emission reductions should be rewarded. While we encourage as early a start date as possible, we feel that ARB’s early action start date of December 31, 2006 appears reasonable. Furthermore, we encourage ARB to work with its counterparts in the WCI to achieve a similar eligibility start date within the multi-state program.

6. **ARB should abandon the concept of “buyer liability”.** The ARB has publicly discussed instituting a policy of “buyer liability”. Although this concept has not been fully defined, Evolution Markets understands it provides the ARB with the ability to look back at credits that ARB staff has issued and, in the event of fraud, misrepresentations, or perhaps mistakes in the regulatory process devalue or reverse.

While we understand that the ARB is concerned with potential reversals in emissions reductions, Evolution Markets believes buyer liability provisions would ultimately inhibit investment in carbon reduction projects, thereby potentially increasing the cost of compliance. Investors are less willing to commit capital to projects, and compliance entities may be hesitant to purchase credits, if there is a risk that the ARB could nullify issued credits and force the buyer to submit additional offsets or allowances. This regulatory uncertainty is not present in other carbon markets, such as the Regional Greenhouse Gas Initiative (RGGI) or the European Union’s Emissions Trading Scheme. Such buyer liability provisions are also not part of emissions reduction credit (ERC) programs that are in place across the U.S. – including California.

Evolution Markets recommends an abandonment of the buyer liability concept in favor of a robust certification and issuance process by the ARB. Once a credit is issued, it should remain so, and the ARB can protect against reversals through a clear and strict process for accreditation.

Should the ARB continue to explore the concept of buyer liability, Evolution Markets recommends establishing tight and specific criteria for regulatory look-back, for instance only in the instance of fraud. Furthermore, ARB should limit the timeframe under which it can look back, such as a restriction on looking back only two or three years from the date of issuance.

B. Specific Protocols

1. **Keep “qualifying facilities” for ODS destruction broad.** Evolution Markets actively structures and executes trades in the rapidly emerging ODS carbon market. Having arranged trades in excess of 10 million CRTs across multiple projects including ODS, Evolution Markets has notable experience to comment on the development of ODS projects under the CAR protocol. It has become increasingly apparent the market experiences a bottleneck stemming from an inability to secure reliable destruction dates at facilities. We understand that despite RCRA-permitted facilities and non-RCRA facilities meeting TEAP Guidelines and having the designation of “Qualifying Facilities” under the CAR protocol, there are no more than a couple facilities prepared to conduct this destruction activity today. This has had a restraining impact on offset supply, which would be especially acute during the critical early years in the program. Given the ARB’s estimates that domestic ODS will generate the largest portion of credits in the program, Evolution Markets recommends that the ARB allow a broader set of destruction facilities to conduct this work. This will make more competitive the marketplace for this activity, which will mitigate the bottleneck risk and will drive down the cost of producing these offsets. These benefits will accrue to Californian’s through a lower cost of compliance.

Thank you for taking time to read through our recommendations and thoughts as you continue the important work for building California’s Cap-and-Trade Program. If you have questions at all, please feel free to contact John Battaglia in our San Francisco office at 415.963.9137, or myself at 914.323.0265.

Yours Sincerely,

(signed)

Lenny Hochschild
Managing Director, GHG Americas
Evolution Markets Inc.

