

California Air Resources Board
1001 I Street
P.O. Box 2815
Sacramento, CA 95812

Dear Chairwoman Nichols and ARB Members and Staff:

Climate Wedge Ltd welcomes and appreciates the opportunity to submit a strong endorsement of the proposed cap-and-trade regulation to implement AB32, as well as the following recommendations during the public comment period. We wish to commend the Air Resources Board (CARB) and both the outgoing and incoming Administrations for your collective leadership and determination to design and implement a well functioning cap-and-trade system for the State of California, which we believe is what has been proposed in this rulemaking.

We respectfully offer the following comments, which are drawn from our team's decade-long active experience in the Kyoto, European, voluntary, and emerging North American carbon markets, having transacted tens of millions of tons of carbon credit transactions on a principal and advisory basis, as well as advised numerous corporations, industrials and large emitters, institutional investors and governments on carbon finance and market-response strategies. We seek here to ensure the California carbon market operates in the most efficient and cost-effective manner in order to deliver upon AB32's stated environmental objectives.

Scope of the Cap

We strongly endorse CARB's approach to setting the scope of a near economy-wide cap, and believe the phased-in approach to bringing in embedded emissions from the fuels sector in 2015 is prudent. We note that mobile and diffuse sources of greenhouse gas emissions have as yet not been regulated under any meaningful cap-and-trade system in other jurisdictions, and as such the introduction of a cap on the fuels sector will create some market and procedural uncertainties which could have an impact on the functioning of the overall market. We are confident that mobile sources can be capped upstream in a robust and effective manner, but believe the phased-in approach will provide the market time to establish abatement costs and demand in the stationary source sector and help provide a reference carbon price signal to the fuels sector in order to help prepare for and anticipate any transitional effects in 2015 and onwards.

Allocation Policy

While we generally remain agnostic as to allowance allocation policies, in this instance we commend CARB for adopting a cautious approach to the use of auctions in the early years of the program. We are keenly aware of the current political environment surrounding greenhouse gas legislation and "cap-and-tax" branding in particular in the United States, and thus believe CARB has been extremely wise in its decision to distribute allowances largely through direct allocation in the early years. This will help deflate political criticism of cap-and-trade as a tax: ***cap-and-trade systems do not inherently have to become implicit carbon taxes on end-use consumers if direct allocation is combined with regulatory control over consumer pricing in the utility sector.*** This is a common misperception in the general public and the media, and one where we

believe much of the political battle over comprehensive climate legislation at the federal level was misplaced.

A well designed and strictly enforced cap-and-trade system with direct allocation to power distributors and regulated consumer pricing by a watchful public utilities commission will largely contain the carbon price signal within the wholesale and generation market. This will have the desired effect of shifting the merit order away from the most fossil intensive sources of generation, while restraining the impact on end-use customers. This does require a disciplined and watchful utilities regulator, which California has, although we grant that this is not a universal truth in other parts of the country or the world. We note that most of the concerns about windfall profits resulting from free allocation to large emitters as witnessed e.g. in Germany and other nations under the European Union Emissions Trading Scheme (EU ETS) will not likely be replicated in California given the regulatory structure here, as generators and utilities will not be able to freely pass on the carbon price to consumers in the State. The price signal needed to affect consumer behavioral shifts to reducing energy consumption will admittedly be damped in this structure, but we note that California has a long and successful history in achieving the objectives around energy efficiency and demand side management through other regulatory tools including efficiency standards and utility incentive schemes.

We thus strongly endorse CARB's prudent allocation policy and hope that it helps defeat the cap-and-tax political argument at the federal level. We are confident that California's cap-and-trade system if designed and implemented correctly will demonstrate that carbon can be priced meaningfully and in a manner which places any cost burden predominantly on the fossil generation sources as opposed to the consumers.

Cost Containment and Offsets

We commend CARB for designing the cap-and-trade regulation with numerous flexible cost-containment mechanisms, in particular banking, rolling three-year compliance periods, and offsets and linkage. We caveat the following recommendations by acknowledging that our firm does have economic interests in offset projects and abatement technologies that may pertain to this part of the rule making.

Increasing the offset cap from 4% to 8% was a welcome decision by CARB and one which we believe will be effective in giving regulated entities additional flexibility in achieving their compliance obligations. We would recommend that CARB monitor the development of the offset market and prices in the allowance market, and consider increasing this cap beyond 8% should prices begin to rise to higher levels than may be tolerable given the prevailing state of the economy. Unlikely other cost containment strategies such as safety valves and offramps, offsets do have the benefit of maintaining the net environmental integrity of the cap, so long as they come from real, verified, additional and permanent reductions. Regulatory scrutiny of the offset market is welcomed and encouraged to ensure that these requirements for offset quality are met.

Regarding eligible offset types and protocols, we welcome CARB's initial selection of protocols and encourage CARB to set in place measures to expand the list of protocols available to compliance entities, so long as there is harmonization with other environmental and regulatory

objectives in the state. For example, we do believe there is logic in CARB's exclusion of landfill gas projects but would note that landfill projects in Mexico are among the most clear-cut cases of high quality, additional offsets in that many are little more than large uncontrolled trash dumps where there are few incentives to control, secure, and sanitize the site other than via implementing a landfill gas carbon project.

We would also strongly endorse CARB's consideration of adopting a REDD+ avoided deforestation protocol. California is currently in a unique position in beginning to implement a new cap-and-trade system which could provide a significant source of demand for pilot REDD+ projects, which are currently excluded both from the EU ETS and the entire Kyoto Protocol framework. REDD projects will not be able to be supported over the long term by the voluntary market, and near-term sources of demand for compliance offsets from REDD+ projects are scarce, recent developments from the COP16 Cancun Agreement on REDD+ notwithstanding. California and Governor Schwarzenegger are to be commended for taking a leadership role in exploring linkages with tropical forest regions in nations such as Indonesia, Brazil, and Mexico for REDD+ projects, and we hope that CARB accelerates its focus on this area for subsequent inclusion in the carbon market here from 2015 onwards.

We note that we have submitted previously comments to the Air Resources Board on certain design recommendations for a REDD+ mechanism in conjunction with a partner of ours, Climate Focus:

<http://www.arb.ca.gov/lispub/comm2/bccommprt.php?listname=sector-based-ws>

Finally, we also recommend that CARB establish a mechanism by which project developers, technology providers, and market participants can propose methodologies for new offset project types directly to CARB for adoption as eligible offsets for the California carbon market. While we commend the good work of the Climate Action Reserve in developing an initial set of protocols for a number of offset project types, we believe the market would be best served if developers and stakeholders can directly propose new methodologies and protocols to CARB for adoption, as this will spur maximum creativity and effort in the search for new abatement technologies and strategies. We note that over its short lifetime, the Kyoto Protocol's Clean Development Mechanism (CDM) has led to the development of hundreds of proposed project methodologies across the spectrum of project types, leading to a considerable amount of intelligence on abatement projects built up in the CDM. The CDM methodology approval process is structured in such an open submission format and has thus harnessed the entrepreneurial energy of the market in developing new abatement technologies and project types. This may well be the biggest legacy of the CDM beyond the volume of tons abated by that particular mechanism, and we encourage CARB to consider improving upon this model in developing its own process for adopting new offset protocols.

Market Oversight

We strongly endorse the principle of strong market oversight for California's cap-and-trade system, as ensuring both the environmental and financial integrity of the carbon market is of critical concern to all market participants. We encourage CARB to reach out to the European Commission and other regulatory and market entities in the EU ETS to understand and learn

from the full set of experiences the EU ETS has had with regards to market breakdowns and manipulations. While most media accounts of fraud and manipulation in the carbon markets are overblown, those that do relate to e.g. the VAT-tax fraud and emission credit registry scams in the EU ETS are serious and must be carefully addressed. Allowance and offset registries must be fully secured and basic know-your-customer (KYC) checks imposed on all entities participating in the market.

However, we do wish to emphasize that carbon credit transactions are often structured in complex and customized formats by entities that are comparatively thinly capitalized and without traditional access to exchanges and clearinghouses. We thus urge caution when designing market oversight rules regulating over-the-counter transactions between market entities and offset project developers, as in many cases these transactions cannot be replicated or placed on an exchange. Project developers and market entities need the flexibility to be able to enter into highly customized, private transactions that are conducted bilaterally, and these types of transactions do not pose a systemic risk to the functioning of the broader market.

Regulatory Certainty

Finally, we close with a high level observation and recommendation: Above all what the market needs in the early years of the program is a robust and stable regulatory environment and rulebook. Carbon markets are inherently subject to a host of uncertainties due to the lack of an underlying physical commodity, and thus are highly susceptible to political and regulatory influences, as we have seen in the shifting regulatory goal posts of the EU ETS or in the SO_x and NO_x programs here in the US. We have on occasion heard CARB staffers refer to the current rulemaking as "version 1.0" and that there will be subsequent versions of the cap-and-trade rulebook as the market evolves. While this need for flexibility in revising particular aspects of the cap-and-trade regulations is understandable and in fact prudent when the market faces uncertain scenarios which could include imperfect design elements of the program, we strongly urge CARB to be conscious of the adverse impacts that this regulatory flexibility may have on market confidence, and to be extremely cautious, disciplined, and consistent when making statements about possible future revisions to the rulemaking.

We cannot overemphasize how much the perceived value and thus price of permits in a compliance market depends on the collective confidence of market entities in the consistency and long-term certainty of the rules. Having the ability to adjust the rules in response to unanticipated adverse developments in the market (e.g. an overallocation or leakage event) can help build and sustain long-term confidence in the market; equally, however, cavalier comments by regulatory staff members or a blackbox approach to adjustments to the rulebook can irreparably damage market confidence and undermine the ability of the cap-and-trade mechanism to deliver on the desired environmental and economic objectives of AB32. We thus strongly urge CARB to clearly establish and communicate to the market the conditions under and process by which the rules of the cap-and-trade system may be adjusted in the future.

We thank you for the opportunity to submit these comments on the design of the cap-and-trade system to implement AB32, and above all wish to commend CARB and the incoming and

outgoing Administrations for a tremendous amount of hard work and leadership in seeing AB32 through to this stage.

We wish all those involved, from the regulators to the regulated entities and the stakeholders in between, a smooth and successful transition to a carbon constrained economy here in California.

Best regards,

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