IETA
INTERNATIONAL EMISSIONS TRADING ASSOCIATION

Climate Challenges - Market Solutions

August 11, 2011

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

On behalf of the International Emissions Trading Association (IETA), I am grateful for this opportunity to provide comments on the modified text for the proposed California cap-and-trade program rules. These proposed regulations include many provisions that will help to drive a greenhouse gas market capable of maximizing both environmental and economic benefits. We hope that ARB considers IETA's perspective and insight as it moves forward with implementation.

IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our 165 member companies include some of North America's, and the world's, largest industrial and financial corporations—including global leaders in oil, electricity, cement, aluminum, chemical, paper, and banking; as well as leading firms in the data verification and certification, brokering and trading, offset project development, legal, and consulting industries. A list of our members is attached.

First and foremost, IETA extends its appreciation for ARB's continued leadership in developing a cap-and-trade program as a principal component of its efforts to reduce greenhouse gas emissions in the State of California. We applaud California regulators for their ongoing efforts to thoughtfully integrate practical, market-based mechanisms that minimize compliance costs while effectively reducing emissions. Market-based mechanisms are the most effective means of pricing carbon, thereby enabling the private sector to invest resources in the most efficient and effective manner while minimizing overall social costs. Moreover, through appropriate market design and roll-out, IETA believes that California's cap and trade program will help transition the region to a competitive, low-carbon economy.

IETA would like to offer the following recommendations as you continue to revise the California cap-and-trade draft regulations:

I. Consider the compliance issues and market distortions that come with the invalidation of offsets;
II. Should offset invalidation policies prevail, strengthen the process for offset invalidation;
III. Extend the period of time to which the quantitative usage limit would apply to the full length of the program;
IV. Streamline the process of accreditation for early action;
V. Expand on the number of eligible domestic offset project types;
VI. Revise auction permit limits and holding limits as well as increase frequency of auctions**;**
VII. Reconsider the 10 percent reduction in allocated allowances starting in 2015;
VIII. Consider enforcement provisions for holding limits in which the responsibility rests solely on the entity in violation of going over the proposed limit.

I. THE INVALIDATION OF ISSUED OFFSET CREDITS AND BUYER LIABILITY

IETA understands in order to maintain the environmental integrity of the California's cap, offsets must be based on well-documented emission reductions. We also understand there may be instances where the documentation California relied upon for issuing an offset credit was not true, accurate, or complete. While IETA believes the likelihood of such a scenario is quite small due to the rigor of California's offset regulations, we must continue to emphasize the need for an appropriate and fail-safe policy response to ensure the program is 'made whole' in rare situations where a reversal would be necessary.

ARB's ability to invalidate offsets would place liability on those entities holding or using offset credits to meet their compliance obligation. IETA warns buyer liability is not a workable approach to addressing post-issuance problems with offsets for the following reasons:

1. **A Buyer Liability Rule Will Prevent the Development of a Viable Offsets Program, Resulting in Adverse Impacts on the Entire A.B. 32 Effort.**

   IETA has strong concerns about ARB's "buyer liability" approach to addressing situations in which problems are identified with offset credits after they have been issued. (See generally section 95985.) To be clear, we believe the risk of such post-issuance problems is small because of the rigor of the ARB offset regulations. However, any policy under which already-issued offset credits carry a risk of invalidation will prevent the development of a market in offsets—and the current provisions make the circumstances very easy for invalidation to occur, as they are very open-ended and non-specific thus giving a "free hand" to the regulator to decide when, where and how to invalidate offsets.

   An unworkable offsets program would have very adverse consequences for the A.B. 32 program, as shown by ARB's own March 24, 2010 economic analysis. As part of this analysis, ARB modeled the regulations under a scenario in which no offsets could be utilized. Relative to the baseline case (in which offsets are utilized to the full 8% limit), ARB's modeling concluded that this "no offsets" scenario would yield allowance prices in 2020 that would be $108 higher ($148/ton instead of $30/ton)—resulting in $18 billion more in costs to compliance entities and subsequently Californian consumers in that year alone.[1] The current buyer liability approach effectively will drive the A.B. 32 program to the "no offsets" scenario.

2. **Buyer Liability is Neither Fair Nor Efficient.**

   In the case of offset discrepancies, it almost certainly will be the offset project operator, verifier, or offset project registry that is at fault—and, under the cap-and-trade regulations, each of these parties submits to the jurisdiction of ARB. Yet, under ARB's proposed buyer liability rules, the holder or user of a credit is presumptively liable. This arrangement turns fairness on its head.

[1] *Id.*, at p. ES-7 (Table ES-2).

In addition, the approach is highly inefficient. To be efficient, a liability system should impose liability on the party that has the most information and ability to control performance as well as minimize the number of legal actions that must be filed to garner a resolution. Most covered entities do not have any special insight into methane digesters, ozone-depleting substances, or forestry. In an offsets program, covered entities will rely on the work of verifiers—and on ARB itself as credit issuer. For this reason, making covered entity buyers liable for problems not detected through the regulatory system will impose substantial new costs on buyers without materially reducing the risk that such problems will occur.

ARB officials also have asserted that buyers can easily and efficiently manage their liability risk through contracts. This view is not consistent with marketplace realities. A viable offsets program will involve the participation of many buyers and sellers—including aggregators who intermediate between smaller covered entities and offset project operators. A buyer liability rule implies a market in which invalidation would unleash a chain of contractual claims involving every party that ever held custody of the credit, paralyzing the marketplace. Aggregators and small businesses will avoid such a market—leaving a stunted offsets program involving only bilateral arrangements by largest covered entities for the largest projects. Small businesses and small projects will fall out of the equation.

3. **Economically Viable Insurance Products Will Not Emerge to Manage Buyer Liability.**

Some ARB officials see insurers coming to the rescue. For several reasons, IETA is skeptical about the emergence of viable insurance products. Insurers typically assess and insure against risks that apply to private activities or enterprises. In an offsets market, by contrast, the risk relates to the performance of a government program—and the ARB offsets system is a government program with no track record of experience. Cost-effective insurance for individual projects/trades are very unlikely to materialize in such a small and idiosyncratic market, particularly in the early stages.

In other types of more mature and "natural" markets, the cost of insurance can come down if offered on the basis of large pools. However, there is no mechanism in the offset regulations that makes such pooling possible for private insurers unless ARB was to purchase insurance on behalf of the market to cover all trades. Still, insurers would always require a deductible and there are the issues as to how to price it based on no direct experience initially. As a result, any insurers for the ARB offsets market would have to build up such pools on their own over time with resulting higher costs—and these costs will be passed through to covered entities in their rates.

Finally, IETA is unconvinced that offset project registries can provide a workable insurance pathway. First, as ARB's own regulations recognize, registries themselves could be the source of a credit discrepancy.[2] Second, registries are not well capitalized, and therefore could not be relied upon to pay out on claims.

[2] See Section 95985(b)(1) (providing that a grounds for invalidation includes a determination by ARB that "information provided to ARB for an Offset Project Data Report or Offset Verification

In sum, a buyer-liability approach is incompatible with an effective offsets program because it is incompatible with the kind of market needed to generate investment in projects. For the reasons mentioned above, a buyer liability approach would ultimately cause each buyer to apply a steep discount to offset credits — or, even more likely, avoid buying offset credits altogether.

IETA understands and shares California's desire to maintain the environmental integrity of the emissions cap, but believes that providing ARB with the ability to invalidate issued offset credits is the wrong avenue to do so. A proposal to invalidate issued offsets is likely to threaten compliance, increase administrative costs, and decrease offset supply.

Because of this, IETA's first recommendation is to establish rigorous offset verification and subsequent certification standards to ensure only quality offsets enter the market. With confidence in every issued offset, retaining the right to revoke offset credits is simply unnecessary.

However, if ARB insists on retaining the ability to revoke issued offset credits, IETA's second recommendation would be for California to adopt a forest buffer account approach on all offsets. We note that ARB has included in the proposed regulations a buffer account that applies for post-issuance problems associated with forest offset projects. IETA strongly urge ARB to apply this Forest Buffer Account to all offset projects. Compared to the buyer liability system, this approach would be: (1) equally effective in making the system whole in the event of invalid credits; (2) far fairer (by holding "bad actors" liable where possible); and (3) much more efficient (again by holding bad actors liable, but also including a system-wide backstop). Why should this kind of approach be workable and appropriate for forest offset projects, but not for other offset project types?

IETA would like to reiterate its proposal modeled roughly on a forest buffer account for unintentional reversals that (1) provides absolute assurances of environmental integrity, and (2) avoids imposing undue administrative risks or costs. IETA's proposal, which is explained in greater detail in the appendix, works as follows:

- Before issuing credits to an offset project, ARB would hold back a certain percentage of credits and place the credits in a Compliance Buffer Account (CBA).

- In the event that ARB determined that documentation supporting an offset credit is materially not true, accurate or complete, then ARB would immediately retire credits from the CBA to replace those that had been invalidated.

- In the event that the credits were invalidated due to a discrepancy that resulted from willful intent or gross negligence, ARB would seek to replenish the credits retired from the CBA from the entity actually responsible for the discrepancy. Requiring the CBA to be replenished in this manner will ensure the long-term viability of the CBA and guard against the moral hazard of lax compliance with the offset program.

Statement by offset verifiers, verification bodies, Offset Project Operators, Authorized Project Designees, or *Offset Project Registries,* related to an offset project was not true, accurate, or complete") (emphasis added).

- In any event, the credits already issued would remain unaffected, but the program would be made whole by retiring credits from the Compliance Buffer Account.

Under this proposal, the market itself — not ARB— bears the risk of flawed credits. In our view, this approach is just as effective in ensuring environmental integrity, but far more efficient and consistent with a robust market. A CBA provides an ironclad compliance backstop resulting in more emissions-reducing offset projects without imposing unreasonable administrative burdens on California.

We understand ARB is reluctant to take on additional administrative or risk burdens, but IETA does not believe such burdens would result. The primary role of ARB under this compliance buffer account approach is to determine the portion of offset credits to set aside in the account. We believe this set-aside should be conservative. In any event, ARB would have the ability to increase the amount of the set-aside if the buffer account runs low. The account requires no active management. It is not a bank account.

II. PROCESS FOR THE INVALIDATION OF OFFSET CREDITS

Regardless of the liability approach ARB adopts, it is important to ensure that the process for offset credit invalidation is well designed. We appreciate many of the modifications that ARB added to the invalidation procedures. However, IETA urges ARB to consider the further modifications outlined below:

1. **Limit the Statute of Limitations to the Earlier of Eight Years or Finalization of a Second Verification.** In the current proposal, ARB has added a statute of limitations of eight years for invalidation of already-issued offset credits. In addition, it appears that a project can shorten the statute of limitations to five years if it undergoes a second verification after three years of issuance of the credits.

   According to this yardstick of credibility, ARB considers the validity of offset credits sufficiently established after the project has been reviewed by a second, independent ARB-accredited verifier and the second verifier has not identified any grounds for validation as set forth in section 95985(b).

   IETA believes this is a well-grounded approach. Also, it provides a basis for minimizing the most problematic aspect of buyer liability: the extended period of time during which an already-issued offset credit remains subject to invalidation. In particular, we think it would lead many entities in the offsets market to manage their risk by obtaining a second verification of each data report immediately following the issuance of credits—which would bolster the credibility of the program. A long statute of limitations would also severely impact the ability to access insurance products.

   To this end, IETA urges ARB simply to allow the invalidation period to expire upon the date of ARB's acceptance of the second verification. We see no reason to require that a second verification "sit" for five years before lifting the shadow of invalidation. Nothing is gained from the passage of time—and yet, the marketplace will not consider the credit valid and marketable for the length of that period.

2. **Eliminate the Condition that Offset Credits may be Invalidated due to Project Information that is not "True, Accurate, or Complete".** IETA urges to ARB modify the provisions under which offset credits may be invalidated.

   Currently, these include four conditions:

   1. The project information is not "true, accurate, or complete" (Section 95985(b)(1));
   2. The project documentation contains errors such that emission reductions achieved by the project are overstated by 5% or more (Section 95985 (b) (2));
   3. The project did not meet all applicable legal requirements (Section 95985(b)(3));
   4. A finding that credits already have been issued for the project in another program ((Section 95985(b)(4)).

   IETA respectfully requests that ARB eliminate the first condition ((b)(1)). Given the myriad requirements of the offset regulations, any number of projects will have documentation that has inadvertent inaccuracies or omissions. Yet, under this vague and overbroad provision, a minor paperwork problem could result in invalidation of 100% of the offset credits already issued for a project—*even if there was no impact on the reductions or removals actually achieve by the project*.

   This is a draconian, "gotcha" approach that will deter development of offset projects for reasons unrelated related to environmental integrity. Furthermore, any discrepancies that *do* have material effects on the environmental integrity of the project are completely addressed by (b)(2), (3), and (4). For these reasons, we respectfully urge ARB to eliminate (b)(1).

3. **Allow Responsible Entities Six Months to Replace Compliance Instruments.** IETA appreciates that ARB has extended the period of time from 30 days to 90 days that an invalidated credit must be replaced.

   Firstly, IETA believes that it should be the responsibility of the project owner or other relevant entity that committed the error (not the buyer) which leads to the invalidation to replace the offsets credits, as discussed above.

   Secondly, 90 days remains a very tight timetable for any entity to obtain replacement credits, particularly if it must obtain a large quantity. IETA respectfully urges ARB to further lengthen this period, and we do not believe that a longer period would impose any particular added burden on the program—or the climate.

   To this end, we note that the regulations allow *six months* in the event of under-reporting of emissions for a covered entity to surrender additional compliance instruments.[3] It is unclear why there should be a shorter period in the context of an ARB determination of offset invalidation under § 95985(c), and therefore respectfully urge ARB to modify the relevant provisions.

[3] Section 95858(c)

III. QUANTITATIVE USAGE LIMIT

As opposed to having an annual compliance obligation, ARB's quantitative usage limit on offsets (currently set at eight percent) will now apply to an entity's biannual compliance obligation for the first compliance period (2013-2014) and triennial compliance obligation for the future compliance periods (2015-2017, 2018-2020).

IETA is generally opposed to quantification limits. As long as only real, permanent, and verifiable offset credits are allowed into the market, arbitrary usage limits will only prevent further reductions of greenhouse gas emissions in a cost-effective manner. Furthermore, offset usage limits applied on the program and entity level inhibits investment in offset projects, particularly those with long-term planning horizons. Investors may be less willing to support development of large-scale or capital intensive offset projects if there is uncertainty as to whether it will be able to monetize the carbon reduction off-take portion of the project. These are the very projects that ARB hopes to foster with the offset program, as they are more likely to employ innovation in sustainable development and create good-paying green jobs.

However, should quantification limits remain in place, IETA believes the modification from an application of the usage limit from an annual calculation to one based on the biannual or triennial compliance period is insufficient. In order to maximize flexibility, and therefore aid in reducing the costs of compliance, IETA recommends ARB extend the period of time to which the quantitative usage limit would apply to the full length of the program—eight years or from 2013 to 2020. The added flexibility ensures each compliance entity has an opportunity to maximize use of low-cost offsets by allowing them to invest in offset projects or purchase offset credits in the market in an efficient and risk-managed manner. In addition, this extension factors in the expectation that offsets are likely to be in short supply, especially at the program's start.

IV. ACCREDATION FOR EARLY ACTION OFFSETS

IETA notes that ARB has modified its rules for creating early action offset credits to now include the process for converting early action credits into ARB-issued offsets.

While IETA is pleased to see ARB recognize early actors that have invested in low-carbon and clean technology projects, IETA has concerns the process for accrediting early action credits and transitioning them to ARB-certified offsets is still too administratively burdensome. A smooth and simple transition mechanism will not only facilitate the process, encourage more projects to seek credit for early action, and reduce uncertainty on the transferability of Climate Reserve Tons and offset credits issued under other qualifying programs, but such a program will also enhance liquidity early in the offsets market which is especially important considering there will likely be not enough offsets to satisfy demand. This also will enable firms to hedge more confidently early in the program, further reducing the costs of the program.

1. Section 95990(d) requires an Offset Project Operator or Authorized Project Designee for an early action offset project to register with ARB before ARB offset credits may be issued. This step should be modified to also allow holders, or owners, of early action offset credits to register with ARB in case there is no interest or incentive to do so on the part of project operators or authorized designees.

2. Sections 95990(h)(5)(A), (B), and (C), require the Offset Project Operator, Authorized Project Designee, or each holder of the early action credit seeking issuance of ARB offset credits to attest in writing the following:

    A. A statement certifying that the greenhouse gas reductions/removals have been measured in accordance with the appropriate early action offset program offset protocol and that all information submitted to ARB is true, accurate and complete.
    B. A statement acknowledging voluntary participation in the California Greenhouse Gas Cap-and-Trade Program subject to the regulatory requirements and enforcement mechanisms and subjecting oneself to the jurisdiction of California as the exclusive venue to resolve any and all disputes.
    C. A statement acknowledging the need to fulfill all applicable local, regional, and national regulatory requirements that apply based on the offset project location, in essence, attesting to the regulatory additionality of the offset project.

    While IETA understands this section relates to ARB attempting to apply its buyer liability rule to early action offset credits, holders of early action offsets cannot make the attestations outlined in (A) and (C) above, as these elements are beyond their control and fall, instead, under the purview of the original project verifier and ARB appointed verifier. IETA strongly recommends these attestations not be required of the project operator, designee, or holder of the early action offset credit seeking issuance. They are an additional administrative burden that may prevent holders of early action credit from seeking issuance, ultimately discouraging participation and disrupting supply. If ARB insists on a buyer liability approach, despite IETA's recommendations and proposed solutions in the previous section, then it will presumably apply to early action offset credits as well and should not warrant a requirement to make the above attestations on the part of project owners, designees, and holders.

Furthermore, IETA recommends ARB provide additional clarification to the provisions dealing with the conversion of forestry offsets to ARB early action offset credits. For instance, IETA is unsure of the intent of Section 95990(i)(E) and would like ARB to clarify its objectives under this section.

V. ELIGIBLE DOMESTIC OFFSET CREDITS

ARB has made no modifications to the draft regulations regarding the list four Climate Action Reserve (CAR) protocols used to classify compliance-eligible offsets and those eligible to receive early action credit. IETA has continued concerns limiting eligible offsets to these four project types alone would cause an immediate supply shortage. We feel there are simply not enough offsets presently available under these four protocols to provide the market with sufficient supply to effectively mitigate costs to California consumers.

Additional paths for generating offset credits should be explored and incorporated into California's cap-and-trade program. These include:

1. **The issuance of offset credits for projects using ARB-approved protocols, beyond the four identified.** Emission reductions from all qualified existing CAR projects should be brought into the compliance system and become compliance eligible. In addition, ARB should consider recognizing protocols from other high-quality carbon project standards

organizations, such as the Verified Carbon Standard, the American Carbon Registry, the Chicago Climate Exchange, and the Gold Standard. Recognizing existing projects will help to create a greater initial supply of offset credits for the market.

2. **The reorganization of offset credits from ARB-approved offset programs.** In addition to expanding CAR offset limits and criteria, state officials must continue to consider how to practically link with external offset and allowance programs, including the Western Climate Initiative (WCI), the Regional Greenhouse Gas Initiative (RGGI), Clean Development Mechanism (CDM), and EU ETS.

There is a great need for ARB to provide more clarity regarding additional project types that may become eligible for offset credit. Developing offsets is a long and complex process that requires significant investment. It can take years for new projects to become market ready. Considering the demand for offsets will only rise over time, giving project investors as much foresight as possible will help ensure adequate supply is available.

In addition, IETA recommends ARB establish an open and defined mechanism through which offset project developers can propose new project types and methodologies for consideration. At the moment, there is no formal path for introducing such methodologies and this would greatly streamline the process.

VI. AUCTION PURCHASE LIMITS, HOLDING LIMITS AND AUCTION FREQUENCY

IETA does not support the adoption of purchase limits or position limits. As discussed below, there is no empirical evidence suggesting that such measures are effective in curbing the risk of market manipulation or market power. To the contrary, experience with carbon markets in Europe demonstrates that the frequency of allowance auctions is in fact the most effective tool in addressing market power issues.

1. Auction Purchase Limits

According to the modified program rules, ARB has increased the purchase limit for future vintage allowances for a single entity from 10 percent of the allowances offered per auction to 25 percent. The limit applicable to current vintage year allowance remains at 10%.

This approach will prevent covered entities with compliance obligations in excess of the limits from purchasing a sufficient number of allowances at each auction that they need to comply with the law. The limitation is a market design flaw because it will create an artificial short on the large covered entities that could result in opportunities for other participants to exercise disproportionate market power. It also places such large covered entities at a competitive disadvantage vis-à-vis other covered entities with compliance obligations below the limit. IETA notes that no carbon market currently in operation contains a similar purchase limit, except for RGGI. In RGGI, however, the purchase limit is 25% and the largest covered entity requires less than 15% of the allowances under the cap to comply.

In order to prevent this unintended effect, IETA recommends the auction purchase limits be revised to provide that all covered entities may purchase up to an amount equal to each individual entity's compliance obligation, plus the current proposed 4% limit granted to non-covered entities. This will ensure that all parties will be on a level playing field and avoid the result of creating a competitive disadvantage to some entities and not others.

2. Holding Limits

Holding limits are difficult to effectively enforce and can actually impede the proper functioning of a cap-and-trade program, particularly in the early years of the program when liquidity is most needed. The position limit contained in the modified cap-and-trade regulations is unprecedented and does not exist in any other major carbon or commodities market. The limit is actually a rule developed by the Commodities Futures Trading Commission for the purpose of limiting financial exposure in futures commodities markets. IETA is concerned that ARB's proposal to extend a rule designed to regulate futures markets to regulate spot (i.e., inventory) markets is both untested and unsupported by the record.

IETA is pleased to see the addition of a holding limits exemption, detailed in section 95920(d)(2). This exemption seems to permit covered entities to hold in their compliance account allowances in excess of the position limit, if such allowances are necessary to meet a compliance obligation. There are a number of issues with the proposed rules. First, as allowances in compliance accounts cannot be withdrawn by their account holders, the rule will result in a number of allowances being taken out of the market early. This will reduce liquidity and increase the ability of any player to manipulate markets. Second, the rule treats large covered entities unfairly by requiring them to comply earlier than their smaller competitors. Such covered entities with large compliance obligations will also be forced to consistently purchase a sufficient amount of allowances per auction, regardless of market conditions, at each auction for placement in their compliance accounts and will be unable to trade these allowances when market conditions improve. This also prevents entities from engaging in hedging strategies that might ultimately save ratepayers money.

Based on the foregoing, IETA recommends that holding limits be discarded or, in the alternative, holding limits be adjusted to permit large covered entities to hold a quantity of allowances equal to the greater of (1) the holding limits currently proposed in Section 95920 or (2) a quantity equal to that covered entity's compliance obligation.

3. Auction Frequency

The modified program rules provides for a quarterly auction schedule, which is inconsistent with the most recent research and analysis conducted in connection with the management of carbon market auctions in Europe. Based on this research and recent market experience, the European Union now requires that, starting in 2013, all auctions be conducted on a weekly basis or more frequently. The concern with infrequent auctions (including quarterly auctions) is that they may result in price volatility and price spikes when the auctions are held and provide more opportunities for the exercise of market power between each such auction. More frequent auctions provide better price signals and help smooth price volatility.

As an alternative to the purchase limits and position limits, IETA recommends that ARB consider conducting auctions more frequently, including for example on a monthly basis.

VII. ALLOCATION OF EMISSION PERMITS

ARB's modified cap-and-trade draft regulations allocate significant levels of permits to covered entities in the early years of the program, moving to an auction of greater volumes of allowances over time. We do notice on July 18, 2012, ARB now plans to transfer 10 percent of benchmark allowances for allocation from budget years 2015-2020 to the Auction Holding Account.

This percentage is significantly increased from the originally proposed transfer of two percent and IETA has concerns about this "haircut" in allocated allowances starting in 2015. At this rate, industry will find it very difficult to adjust to the increased costs of auction, threatening competitiveness, jobs and consumer energy prices. Furthermore, allocating allowances helps to minimize leakage and prevent California industries from being put at a competitive disadvantage.

Significant time and capital investment are needed to meet long-term emissions reductions goals and transition California to a lower-carbon economy. IETA recommends this ten percent haircut be returned to the original two percent. This will better help participants acclimate to the market and permit time for large capital investments to yield emissions reductions, keeping costs down, reducing trade exposure, and improving efficiency.

VIII. CONDUCT OF TRADE

Under proposed modified Section 95921, ARB creates rules relating to the conduct of trading in compliance instruments. In effect, ARB grants the Executive Officer the ability to reverse transactions that violate, in part, holding limits specified in Section 95920.

Notwithstanding IETA's comments above on the issue of Holding Limits, we understand the need for ARB to develop an enforcement mechanism for these rules. However, IETA is concerned that the mechanism outlined in Sec. 95921 provides ARB an unprecedented enforcement power, which ultimately could be detrimental to trading liquidity and the ability for entities to hedge price risk and comply with carbon reduction targets at the lowest possible cost.

Reversing commercial transactions between counterparties creates a host of contractual and compliance issues. A fundamental tenet of a properly functioning market is that commercial contracts between counterparties cannot be unwound. An obligation to sell allowances to another counterparty must be met, and once the transfer of allowances and cash has taken place counterparties cannot be expected to reverse this transaction.

To create the possibility of a transaction reversal would introduce an unacceptable measure of risk to carbon transactions. Sellers would be exposed to undue price risk in the interim between the transaction and the transfer, and a reversal might present market risk that impedes implementation of hedging strategies.

Furthermore, such reversals may create a daisy chain of violations of holding limit provisions. In the instance of ARB reversing a transaction, the buyer of allowances will return the allowances to the seller. The seller may have sold the allowances to ensure it did not violate its own holding limits, and the return of allowances from the reversed transaction might then put the seller over its holding limit. This would, in turn, generate another series of reversals that would impact still other counterparties.

Importantly, a seller will have no insight into the holdings of the buyer, and therefore should not be responsible for returning cash to the buyer and taking back allowances in instances where the seller is over the proposed holding limit. IETA, instead, suggests ARB consider enforcement provisions for Holding Limits in which the responsibility rests solely on the entity in violation of these provisions. IETA encourages ARB to consider such enforcement that does use market transactions (or reversal thereof) as the mechanism for compliance.

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Once again, on behalf of IETA and our 165 member companies, I would like to thank you for providing the opportunity to comment on the modified text of ARB's cap-and-trade draft regulations and for your attention to these comments. Please do not hesitate to contact me or Ethan Ravage in IETA's San Francisco office if you have any questions.

Sincerely,

Henry Derwent

Henry Derwent

APPENDIX

Outline of Compliance Buffer Account as a Means for Handling the Invalidation of Offset Credits

A summary of IETA's proposal to address materially flawed documentation associated with already issued offset credits is set forth below in outline format. Our proposal relies upon a CBA that is funded by a holdback on the issuance of offset credits. While the CBA approach is modeled on the forest buffer account commonly found in cap-and-trade regulations like California's, the proposed CBA is intended to be entirely independent of a forest buffer account. The practical management of the two accounts will be very similar, but they protect against different risks and therefore should be funded and maintained separately.

There are three basic elements of the CBA approach outlined below: (1) due process for invalidation determinations (the need for which is the same under a buyer liability approach), (2) accessing the CBA in the event credits are invalidated, and (3) funding and managing the CBA. In effect, the CBA approach described here is a market-funded self-insurance mechanism that ensures the environmental integrity of the offset program.

1. Invalidation Determinations — Adequate & Appropriate Process.

The invalidation of any issued offset credit by WCI regulatory authorities — whether in a holding account or already used for compliance purposes — shall be based on a determination that the documentation provided by an Offset Project Operator, Offset Project Designee, Verifier, or Offset Project Registry is materially *not* "true, accurate, or complete." A determination that documentation is materially not "true, accurate or complete" shall be based on protocols, information, methods, processes and regulations applicable and in place at the time the documentation was prepared. Invalidation shall not be based on evolving standards, processes, science, opinion, or on regulatory or legislative changes that take place after the preparation of the original documentation, including but not limited to any modification of offset protocols.

a. If WCI regulatory authorities <u>makes a determination</u> to invalidate an offset credit, it must follow a process that ensures due process, including:

(1) The determination shall be subject to a seven-year statute of limitations based on the date of credit issuance for the credits at issue.

(2) The determination shall be in writing. The written determination shall clearly state the reason(s) for the determination, and shall identify all those associated with the invalidated credits (*e.g.*, the Offset Project Operator, the Authorized Project Designee, the Verifier(s)).

(3) If possible, WCI regulatory authorities shall identify in the determination the entity(ies) directly responsible for the invalidation due to the generation of offset credit documentation that is materially not true, accurate, or complete – *i.e.*, the responsible entity(ies).

(4) WCI regulatory authorities shall issue a Notice of Invalidity Determination to all those associated with the invalidated credits, informing them of the determination, providing them with a copy of WCI regulatory authorities' written determination, and advising them of their appeal rights.

(5) The determination shall be subject to an administrative appeal to WCI regulatory authorities' Administrative Hearing Office.

- A party appealing an invalidation determination must replace the credits pending the outcome of the appeal. In the event that it prevails on appeal, credits will be returned to it from the CBA.

2. Remedy in the Event of an Invalidation Determination — Retirement of Credits from the CBA and Enforcement Against Responsible Entities.

a. Immediate Retirement of Credits from the CBA.

(1) WCI regulatory authorities shall immediately retire from the CBA a number of offset credits equal to the number that were subject to the invalidation determination.

b. Replenishing the CBA after Credits have been Retired to Replace Invalidated Credits — Enforcement Against Responsible Entities.

(1) If in its written determination WCI regulatory authorities identifies the entity(ies) responsible for the invalidation due to the generation of offset credit documentation that is materially not true, accurate, or complete, and determines that the invalidation was the result of gross negligence or willful intent, then WCI regulatory authorities, when it issues the Notice of Invalidity Determination to any entity identified as a responsible entity, also shall issue a demand to that entity that it replenish the offset credits retired from the CBA within sixty (60) days.

(2) WCI regulatory authorities may consider the record of invalid documentation when assessing market participants' applications to register with the WCI and participate in the market.

3. Funding and Managing the CBA.

a. Funding the CBA.

(1) The CBA shall be funded by requiring a 1.5% holdback on the issuance of all offset credits from offset projects.[4]

[4] The 1.5% figure was calculated by analyzing the leading carbon market offset programs, including the Clean Development Mechanism and the voluntary carbon offset programs of the Climate Action Reserve and the Verified Carbon Standard ("VCS"). The CDM provides the most robust

b. Managing the CBA.

(1) WCI regulatory authorities shall manage the CBA.

c. Adjusting the Holdback to Ensure Adequate Funding of the CBA.

(1) WCI regulatory authorities shall review the CBA at the end of each compliance period and may, on a showing of good cause, change the amount of the holdback for new projects or projects entering a new crediting period in order to ensure that the CBA is adequately funded.

(2) If the CBA is running low prior to a regular review cycle, WCI regulatory authorities can explore options and undertake actions to increase it.

(3) If the compliance account grows overly large, WCI regulatory authorities shall reduce the holdback percentage for the next compliance period. The extra credits shall remain in the CBA to further enhance the environmental integrity of the program.

data set for this analysis, due to the availability of more than five years of credit issuance data, sufficient transparency in the credit issuance process, and the compliance nature of the program.

We found ***no*** known instances of fraud in the CDM nor in the two voluntary carbon offset programs. Erroneous issuance is difficult to determine, but the CDM provides a useful proxy: issuance rejections. The CDM process empowers its Executive Board to reject credit issuance requests from project owners, and the Board has done so 34 times out of 2,573 requests as of April 18, 2011. The 34 issuance rejections total 5,768,738 tCO2e out of 598,143,088 tCO2e of credits issued, or 0.96%. Informal discussions with CAR and VCS personnel suggest that their respective rates of erroneous issuance are actually far below the CDM's rate of issuance rejection.

We believe the WCI's carbon offset program will be even more robust than the CDM, and as a result should have rates of erroneous issuance that are well below the historic rates of the CDM. For this reason we believe an initial holdback of 1.5% is conservative.