



745 Seventh Avenue
New York, NY 10019
United States

August 11, 2011

Clerk
California Air Resources Board
1001 I Street
Sacramento, CA 95814

RE: California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms

Dear Clerk:

Barclays Capital ("Barclays")¹ is grateful to the California Air Resources Board (the "Board" or the "ARB") for the opportunity to comment on the changes that the Board is proposing for the California Cap-and-Trade Program rules.² We acknowledge and appreciate the Board's continued efforts in developing an effective cap-and-trade program based on efficient market tools. Our comments are intended to offer practical insights drawn from our perspective as a market participant and, more importantly, as a risk manager to our clients.

In its role as a seated Director to both the International Emissions Trading Association ("IETA") and Environmental Markets Association (the "EMA"), Barclays endorses the comments regarding holding limits and buyer liability filed by IETA and the EMA, both on August 11, 2011, with the following additional comments.

A. Holding Limits

1. *Decreased Liquidity and Increased Risk*

Barclays strongly believes that holding limits, in their current and proposed form, should be excluded from the proposed rules. Furthermore, to safeguard the market and limit individual instances of market manipulation, we recommend that the ARB rely on existing Commodity Future Trading

¹ Barclays is the investment banking division of Barclays Bank PLC and provides large corporate, governmental and institutional clients with comprehensive solutions to their strategic advisory, financing and risk management needs. With offices around the world and over 25,000 employees, Barclays has a significant global presence in the emissions markets serving power, industrial, transportation, offset developing, and institutional clients. It is the largest liquidity provider of environmental market-based compliance mechanisms in the world, having traded more than 5.5 billion tonnes of carbon credits with a total notional value of approximately \$89 billion. In addition, it was the creator of the Standard Certified Emissions Reduction Forward Agreement ("SCERFA"), which established an industry standard set of trading terms to promote secondary market trading for compliance-grade Certified Emissions Reductions ("CERs") in the European Union. It was also co-developer of the Carbon Allowance Forward Trade Agreement, which standardized terms for the forward trade of California Carbon Allowances.

² California Code of Regulations. *California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms*. California: California Environmental Protection Agency Air Resources Board, 2011. Title 17, §§ 95800 – 96022 (the "proposed rules").

Commission (“CFTC”) and designated contract market (“DCM”) rules and their oversight of the commodity markets.

Holding limits, as currently proposed, will serve to decrease liquidity and compromise market efficiency while increasing the costs of risk management. Ultimately, this will pass increased costs along to the consumer. For example, if covered entities are in danger of breaching their holding limits, they may be forced to either transfer excess allowances into their compliance accounts, or to sell their allowances into the market at a time and at a price which may not conform to approved hedging programs.

Transferring allowances into a covered entity’s compliance account precludes further trading of those allowances, thereby taking them out of the system.³ Although such allowances would eventually have been retired for compliance and removed from the system, holding limits require that they be removed from the system earlier than necessary. This could lead to large quantities of allowances being removed from, or potentially never being introduced into, the system, resulting in a substantial loss of liquidity. Furthermore, without the supply or liquidity necessary to satisfy demand from electricity importers, electricity generating units and other capped sources, artificial shortages could result and eventually lead to higher compliance costs.

Holding limits may force registered entities to sell compliance instruments in conflict with their legitimate and ordinary course hedging and risk management strategies. If legitimate hedging and risk management strategies are artificially constrained by regulatory limits, then covered entities may be forced to engage in short term and non-fundamental trading instead. Exceeding holding limits will be less risky to registered entities and the market at large than interrupting well executed risk mitigation and hedging strategies.

For example, electricity generating units rely on forward markets for the pricing necessary to pay for and lock-in generation costs. Input costs, such as fuels, transmission and capacity payments, are often fixed in advance. Carbon becomes another input cost to be hedged alongside all other costs. Holding limits could force a delay or timing discrepancy in utility hedging programs if carbon allowances cannot be priced at the same time as all other costs. Furthermore, untimely purchases and sales could leave market participants exposed to unfavourable market conditions.

Holding limits undermine the system’s intended banking benefits. Banking is included in most emissions trading systems to provide cost containment and to allow hedging programs to smooth compliance pricing out over several periods. Holding limits undermine the intended purpose of the banking provisions of the cap-and-trade rule by removing the flexibility provided by banking guidelines. That is, electric generating units with excess allowances may be able to reserve them for future compliance use, but they cannot carry inventory to manage future pricing and/or demand requirements. In effect, holding limits override the benefit of emissions banking.

Ultimately, the increased risk and decreased liquidity associated with holding limits will deter the growth of this nascent market. This will increase the cost of compliance with the Cap-and-Trade Program, which will eventually lead to increased costs to California energy consumers.

³ 17 C.C.R. § 95831 (a)(4) (B) (B) (“A compliance instrument transferred into a compliance account may not be removed by the covered entity.”).

2. *Holding Limits are a Unique Constraint on a Physical Commodity Market*

Generally, physical commodity markets are not subject to holding limits. Although the CFTC and DCMs impose position limits and position accountability levels on futures contracts, physical positions are not so limited.⁴ Even with respect to future contracts, entities are exempt from such limits to the extent they are engaged in “*bona fide* hedging transactions.”⁵ This exclusion to the CFTC and DCMs’ position limits has existed since 1936 and covers “various balance sheet and trading strategies that are risk reducing...”⁶ Accordingly, even under the CFTC and DCM rules, an entity can pursue risk reducing hedging strategies that breach position limits.

We see no reason that allowances should be treated differently from any other commodity. Similar to other commodities, regulated entities should be able to trade allowances in the physical market without holding limits. Even if the Board does not adopt this view, it should not drive against over 75 years of history that exempts *bona fide* hedges from trading limits and should adopt a similar exclusion to the proposed rules’ holding limits.

Furthermore, the CFTC will be able to indirectly exercise anti-manipulation jurisdiction over the physical allowance market. The CFTC may regulate physical markets that relate to and affect a futures market.⁷ Because allowances will be listed on an exchange, the CFTC will be able to regulate and punish market manipulation of physical allowances.⁸ The Board should not intrude on the CFTC’s jurisdiction by imposing holding limits, and should instead rely on the CFTC and the exchanges’ expertise and experience in this area.

⁴ This will also apply to swap execution facilities under the proposed regulations relating to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) (H.R. 4173, 111th Cong. § 737 (2010). § 737 (2) (“SPECIFIC LIMITATIONS.—In establishing the limits required in paragraph (2), the Commission, as appropriate, shall set limits—(A) on the number of positions that may be held by any person for the spot month, each other month, and the aggregate number of positions that may be held by any person for all months; and (B) to the maximum extent practicable, in its discretion— (i) to diminish, eliminate, or prevent excessive speculation as described under this section; (ii) to deter and prevent market manipulation, squeezes, and corners; (iii) to ensure sufficient market liquidity for bona fide hedgers; and (iv) to ensure that the price discovery function of the underlying market is not disrupted.”)).

⁵ CFTC Testimony -- Dan M. Berkovitz, http://www.cftc.gov/PressRoom/SpeechesTestimony/proposedrule011410_berkovitz.html.

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⁷ For example, British Petroleum paid \$150 million in fines to the CFTC in connection with the settlement of an alleged manipulation of the propane market. British Petroleum purchased a large percentage of the physical market for TET propane. The CFTC alleged that even though British Petroleum did not purchase futures, its purchase of physical propane affected the physical contract. *See* British Petroleum to Pay More than \$370 Million in Environmental Crimes, Fraud Case, Department of Justice (October 25, 2007).

⁸ This authority will be augmented under the Dodd-Frank Act, under which the CFTC has jurisdiction over manipulation and attempted manipulation “in connection with any swap or contract for sale of any commodity in interstate commerce or contract for future delivery on an exchange.” 17 CFR § 180.2.

B. Buyer Liability

We have serious concerns about ARB's "buyer liability" approach to addressing situations in which problems are identified with offset credits after they have been issued.⁹ Any policy under which already-issued offset credits carry a risk of invalidation will prevent the development of a market in offsets, limit allowance supply for California large emitters, and may increase compliance costs

In 2005, Barclays created and promoted the development of an efficient and liquid secondary market for CERs, for compliance under the Kyoto Protocol with the European Union's Emission Trading System. SCERFA, which covered the trading of CERs, opened a fair and efficient market for trading offsets. It was fair in that access to small participants was enabled. It was efficient in that transaction cost normally lost to intermediaries could accrue directly to the offset project owners. This was possible only because a secure and thorough pre-issuance process supported permanent offset issuance.

We believe an aggressive and secure pre-issuance process can provide regulators with the certainty to issue offsets permanently. Absent relying on a secure issuance, ARB could consider an alternative to the cancelling of credits that would not impair the compliance value of issued offsets. Swapping and cancelling equal numbers of viable offsets in a compliance buffer account for offsets subject to invalidation proceedings could relieve this risk. Alternatively, ARB could follow the procedure for invalidating CERS and require verification bodies that wrongly verify offset allowances to procure and extinguish an equal number of allowances. However, should the Board retain the offset invalidation rules as they are currently proposed, the statute of limitations on the invalidation of offsets could be reduced from eight (8) to not more than two (2) years.

These measures will help ensure that normal market transaction rules reduce cost and increase market transparency and fairness. At present, buyer liability will undermine a liquid, and efficient market open to all. Instead, offsets will become a high-risk private investment exercise suited only to a small number of specialist intermediaries.

1. *Buyer Liability Rule Will Limit Offset Project Development and Reduce the Emission Reduction Value of the program*

Buyer liability will significantly increase the overall cost of the California Cap-and-Trade Program. Buyers of offset allowances will demand lower prices to reflect their risk that offset allowances could be invalidated. This will likely result in a large discount for offset allowances

⁹ See generally 17 C.C.R. § 95985 (a) ("An offset credit issued by ARB under this Article will remain valid: (1) until the offset credit has been retired or surrendered for compliance in any voluntary or regulatory program; or (2) unless invalidated pursuant to section 95985(b). (b) An offset credit may be determined to be invalid for the following reasons: (1) a finding pursuant to section 95983 that a reversal occurred in a forest sequestration project; or (2) ARB has determined that errors by verifiers, verification bodies, Offset Project Operators, Authorized Project Designee, or others involved in producing the documentation used to support the issuance of offset credits are sufficient to warrant a reversal. (c) If ARB determines that an offset credit issued is invalid pursuant to this section: (1) the offset credit will be cancelled and removed from any Holding or Compliance account or the ARB Forest Buffer Account; (2) the current holder, user, or retiree of the offset credit will be notified at the time of ARB's determination; and (3) any approved program for linkage pursuant to subarticle 12 will be notified of the invalidation at the time of ARB's determination.").

relative to non-offset allowances. Low pricing will not provide the necessary incentive for emission reduction project to be developed.

ARB modelled 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 modelling 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 in that year alone.¹⁰ The current buyer liability approach effectively will drive the A.B. 32 program toward the "no offsets" scenario, resulting in significantly increased compliance costs.

2. *Economically Viable Market Solutions to Buyer Liability will not be Forthcoming*

Some ARB officials see insurers coming to the rescue. For several reasons, we are sceptical 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 not only to identifiable actor failures to perform, but also to the performance of a government program. This form of regulatory risk is very difficult to measure in general, but more so in a new and untested regime. Cost-effective insurance will not materialize in such a small and idiosyncratic market.

Under similar programs, companies have attempted to secure third party coverage from large insurers as well as re-insurers to mitigate buyer liability risk. Both internationally and domestically, these efforts have failed to yield a satisfactory insurance product covering compliance exposure. This risk is difficult for insurance markets to quantify because: (a) one ton of offset allowance may or may not have equivalent monetary value between two periods; and (b) the market replacement cost may only cover part of the exposure. In the end, it is more than a market risk issue. Rather, it contains elements of regulatory, reputational and market risk. That part of the equation has proven to be unquantifiable in many instances, particularly over very long time periods.

The proposed rules also contemplate that offset project registries may offer voluntary insurance products to protect against buyer liability risks.¹¹ We are sceptical 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.¹² Second, registries are not sufficiently capitalized, and even with third party balance sheet support (insurance), cannot necessarily be relied upon to pay out claims.

We believe that the ARB should reconsider offset invalidation procedures and instead rely on the pre-issuance process. Multiple verifications over sequential operating periods can provide the necessary safeguards. If enough security cannot be provided pre-issuance, then we further encourage the consideration of a much shorter period over which issued offsets can be subject to invalidation

¹⁰ California Environment Protection Agency, *Updated Economic Analysis of California's Climate Change Scoping Plan: Staff Report to the Air Resources Board*, ES-7 tbl ES-2 (2010)

¹¹ 17 C.C.R. § 95987 (k) ("The Offset Project Registry may choose to offer an insurance mechanism to cover the invalidation of ARB offset credits, but purchase or use of the insurance mechanism will be optional for all entities involved with ARB offset credit transactions.").

¹² See 17 C.C.R. § 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 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).

proceedings. Post issuance, multiple verifications of sequential operating periods together with rotating verifier assignments could support a shorter “at-risk” period and provide comfort.

Regardless of the final form of the rule, the focus of any change should be on reducing compliance entity risk and cost. The result will be a fairer, more efficient program overall.

C. Conclusion

Barclays believes that the proposed rules stance on holding limits and buyer liability will lead to decreased participation and liquidity in the allowance market. We ask the Board to reconsider its position on these issues in order to ensure the success of the California Greenhouse Gas Cap-and-Trade Program and corresponding allowance and offset market.

Sincerely,

/s/ Kedin Kilgore

Kedin Kilgore
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