



August 10, 2011

Mary Nichols  
Chair  
California Air Resources Board  
1001 I Street  
Sacramento, CA 95812

**RE: Comments to Air Resources Board Cap-and-Trade Regulation 15-day Change Proposal from CE2 Capital Submitted on-line**

Dear Chair Nichols,

Thank you for the opportunity to comment on ARB's cap and trade regulation 15-day change proposal. We appreciate you and your staff's willingness to discuss changes to the regulation and look forward to working with you in the future to create a cap and trade program with integrity. Below are our comments on the existing regulation.

**1. Offset Invalidation (Section §95985(f))**

ARB is currently considering two approaches to ensure that the carbon emission reductions achieved by offset projects remain permanent. The first is by holding regulated entities responsible for replacing any invalidated credits. The second is an innovative solution currently used to address intentional forestry offset project reversals whereby the forest owner is first responsible for replacing the offset credits. Any credits they do not replace within 90 days are retired by ARB from a "Forest Buffer Account" created by a small percentage of offsets contributed by *all* forestry projects. We propose that instead of the first approach, ARB require that all offset projects follow the second type of system through a separate buffer account, an "Invalidation Buffer Account."

*The Problem*

Unfortunately, requiring regulated entities to replace invalidated credits will unnecessarily restrict the supply of high quality offsets without real net environmental gains. The problem lies in the assumed benefits of this system. Buyers (regulated entities) are assumed to be protected from receiving bad credits through use of insurance mechanisms, trained offset verifiers, innovative contracting, and extensive due diligence. It is also assumed that ARB is more likely to recover an invalidated offset credit if a regulated entity is held liable for its replacement. There are several fundamental problems with these assumptions:

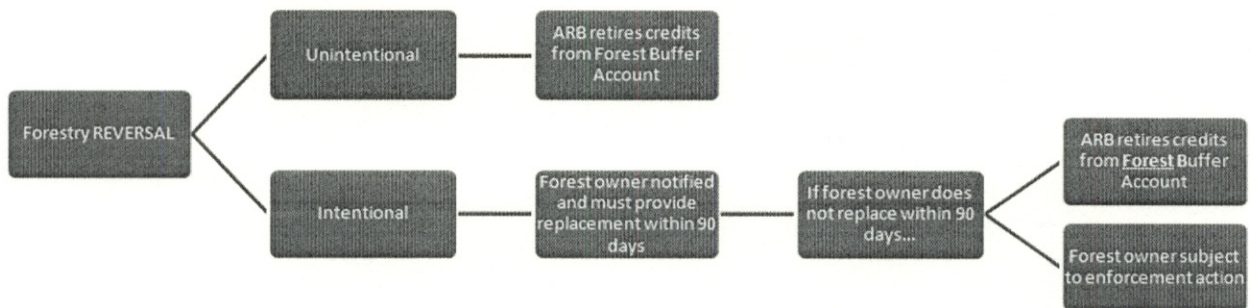
- a. No private carbon offset insurance products currently exist. Given the low overall number of potential offsets that can be used in the California market (up to 232 MMTCO<sub>2</sub>e) it is not practical to assume that a product will be actuarially viable, cost effective or emerge. If ARB

- believes this product is or could be available and cost effective, ARB should define the parameters of an acceptable policy and mandate its use.
- b. The private sector cannot mandate that all projects and offset holders purchase a common insurance policy or participate in a common buffer account. Without a common policy or buffer account, economies of scale cannot be achieved and transaction costs will increase thereby decreasing the cost containment effectiveness of offsets and decreasing investment in emission reductions outside of the capped sectors.
  - c. If a voluntary insurance policy or buffer account were to exist, it would suffer from “adverse selection” as (1) project developers and sellers would be incentivized to submit only their riskiest projects to the voluntary insurance policy or buffer account; and (2) they would sell the least risky projects directly to large compliance entities via bilateral contract.
  - d. If only the riskiest projects trade on exchanges, transparency will be sacrificed and market oversight will be more difficult.
  - e. Smaller compliance entities would not have equal access to quality offsets. Larger entities are better able to diversify invalidation risk across multiple projects and counterparties and devote staff to evaluating the invalidation risk of individual offset projects.

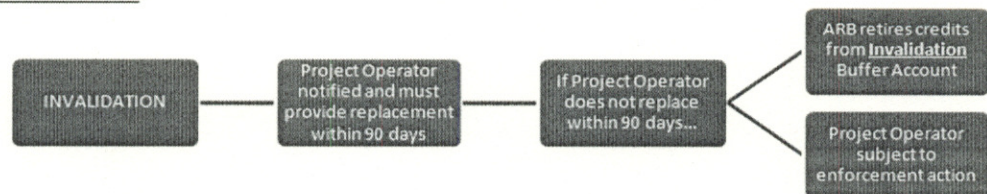
### *The Solution*

In our view, the solution to addressing the problems associated with holding regulated entities responsible for replacing an invalidated offset credit is to mirror the current ARB Forest Buffer Account structure and procedures<sup>1</sup> to apply separately (and additionally) to all Compliance offset projects. A simple diagram of both the existing and proposed structure for developing a new “Invalidation Buffer Account” is shown below:

#### Current ARB Forestry Reversal Procedure:



#### Proposed Invalidation Procedure:



Once an offset is invalidated by ARB, the first step would be to notify the Offset Project Operator and allow them 90 days to replace the invalidated credits. If the Offset Project Operator does not replace



the invalidated credits within 90 days, ARB would retire credits from the ARB Invalidation Buffer Account. If the credits are not replaced with 90 days of ARB's retirement, the Offset Project Operator would be subject to enforcement action. This system would reduce transaction costs while maintaining environmental integrity in the overall cap and trade system. This system would also align the incentives of Offset Project Operators, verifiers, buyers, sellers, and regulated entities, as well as result in a fungible, commoditized offset market which is equitable, accessible by all compliance entities, and would allow transparent trading and clearing via exchange.

Relying on the establishment of an Invalidation Buffer Account could be seen as increasing the risk of default to ARB and placing new administrative burdens on an already stressed ARB staff. However, the changes proposed herein are merely an extension of the buffer account management and enforcement action responsibilities already undertaken by ARB for forestry projects, and will actually reduce invalidation risk because the incentives of Offset Project Operators will be properly aligned to ensure the quality of their projects.

## **2. Statute of Limitations on Offset Invalidation (Section §95985(b)(6))**

The current language allows for the potential to reduce the Statute of Limitations on offset invalidation from eight years to five if the project is verified by a different verifier after three years, versus the requisite six years. The regulation should include two additional options:

- a. Eliminate the Statute of Limitations if the Offset Project Operator or Early Action offset holder elects to use two different verifiers at the time of verification for Compliance projects or regulatory re-verification (i.e. desk review) for Early Action offsets; and
- b. Allow the Statute of Limitations to be reduced to two years if a project voluntarily uses a different verifier after one year.

These options allow more flexibility and would continue, as stated in the regulation, to, "encourage a quicker verifier rotation so that any issues that may occur may be uncovered sooner, further enhancing the integrity of the offset program."

## **3. Definition of "in business" (Sections §95985(f) & §95990(l))**

The regulation includes a provision whereby ARB would look to the Offset Project Operator, Authorized Project Designee, and/or original holder of the Early Action offsets to replace any invalidated offsets if the forest owner or end-user is no longer "in business." Please define "in business" and clarify what circumstances would trigger this action.

## **4. Early Action Offsets (Section §95990(l) & §95990(f)(3)(E))**

In the case where an Early Action *forestry* offset holder that chooses to transition their issued offsets to ARB but the forest owner and/or Offset Project Operator choose not to transition the entire project, please clarify whether the invalidation risk would be borne by the forest owner or the Early Action offset holder who transitioned the offsets to ARB. Please note that in many cases the Early Action offset holder has no contractual link to the forest owner and may not be able to compel the forest owner to transition their project to ARB.

If an Offset Project Operator and/or Authorized Project Designee does not transition an entire Early Action project to ARB but the current Early Action offset holder wishes to transition their issued offsets, the language relies on the Early Action Offset Program to submit the Early Action Verification Report(s) to ARB. However, the potential Early Action Offset Program we have spoken to (the Climate Action Reserve) has stated they are unsure whether they have the authority to submit Early Action Verification Reports to ARB. This could be a substantial obstacle to transitioning Early Action offsets and could decrease the availability of offsets in the program. Please help clarify what action the issued Early Action offset holder may take if both the Offset Project Operator/Designee and the Early Action Offset Program decline to submit the Early Action Verification Report(s) to ARB.

**5. Auction Purchase Limits (Section §95911(c))**

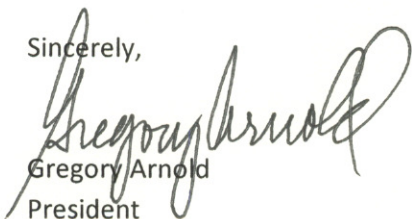
Purchase Limits should be waived or increased in the event that allowances would otherwise go unsold in an auction.

**6. Unsold Auction Allowances (Section §95911(b)(4)(A)&(B))**

CE2 supports the language that requires unsold current vintage allowances to be transferred to the Price Containment Reserve, equally to the three tiers. We recommend unsold future vintage allowances should also be transferred to the Price Containment Reserve rather than returned to the Auction Holding Account.

Please do not hesitate to contact us if we can answer any questions or clarify any of our comments above.

Sincerely,

A handwritten signature in black ink, appearing to read "Gregory Arnold", is written over the printed name and title.

Gregory Arnold  
President