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August 11, 2011

Mary Nichols, Chairman
James Goldstene, Executive Officer
California Air Resources Board
1001 I Street
Sacramento, CA 95812

Subject: South Coast Air Quality Management District (SCAQMD) staff comments on Proposed 15-day Changes to California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms

Dear Ms. Nichols and Mr. Goldstene:

The South Coast Air Quality Management District (SCAQMD) staff appreciates the opportunity to comment on the State's proposed 15-day changes to the cap and trade program.

As the largest air district in the state, covering approximately 40 percent of the population and hundreds of the facilities that will be in the cap and trade program, we want to lend our expertise and experience to assist the California Air Resources Board (CARB) with this effort. We have provided numerous comment letters and briefings to share our 17 years of implementing RECLAIM, a multi-pollutant cap and trade program. We have learned first-hand how challenging and resource-intensive such a program can be, but at the same time how successful it can be, if designed properly and implemented effectively, to reduce emissions with greater flexibility and lower cost to industry.

We commend and support CARB staff for their work on the proposed 15-day changes, but are disappointed that CARB has not worked more closely with SCAQMD and CAPCOA during this process. We remain committed to partnering with CARB and offer the following comments to enhance the program and help ensure its success.

Our comments are organized in three sections. The first section provides suggestions for improving areas of the rule that are the subject of the 15-day changes. The second portion of the comments reiterates SCAQMD requests that air districts be allowed to perform multiple roles for the cap and trade program implementation. The last section includes additional recommendations on areas of the rule that

are not proposed for changes but for which SCAQMD staff continues to have concerns. These comments are offered based on decades of experience with both command and control and cap and trade programs.

I. Comments on 15-day Changes

Section 95812: Inclusion Thresholds for Covered Entities and Section 95813: Opt-in Entities

In subdivision (e) if a facility leaves the program because its emissions drop below the threshold level it is not clear what happens to any allowances it has received free of charge. It also is not clear from the rule language whether leaving the program because of a decrease in emissions is optional or mandatory. We suggest a clarification of the consequences associated with a decrease in emissions and a provision similar to Section 95813 subdivision (f) for opt-out of opt-in entities, requiring surrender of allowances.

The potential impact on meeting the overall 2020 emission reduction goal for facilities initially in the program or opting-in that subsequently go below the threshold for inclusion and drop out of the program should be assessed. The combustion emissions will be controlled by having the upstream fuel under the cap after 2015, but other greenhouse gases would not be. This could potentially compromise the ability to meet the 2020 reduction target. Also, we assume that facilities must reenter the program if their emission threshold subsequently increases. Having facilities move in and out of the program as their emissions fluctuate will also add an unnecessary administrative burden. We recommend that once a facility is in the cap and trade program they remain in, even when their emissions drop below 25,000 MT CO_2e per year.

Section 95831: Account Types and Section 95857: Untimely Surrender of Compliance Instruments by a Covered Entity

These two sections seem to conflict. Section 95831paragraph (b)(4) describes the "Allowance Price Containment Reserve Account" and subparagraph (b)(4)(C) specifies that the Executive Officer transfer to this account "the serial numbers of allowances submitted to fulfill an entity's excess emissions obligation pursuant to Section 95857 (d)." Section 95857 subdivision (d) specifies that the Executive Officer transfer three fourths of the "allowances used to fulfill the untimely surrender obligation" to the Auction Holding Account and one fourth to the Retirement Account.

The paragraph (b)(4) language "allowances submitted to fulfill an entity's excess emissions obligation" refers to the three fourths portion of the untimely surrender obligation to be transferred to the Auction Holding Account pursuant to Section 95857 subdivision (d). Section 95857 subdivision (d) has the same amount being deposited in a different place – the Auction Holding Account. This conflict can be resolved either of the following two ways depending on which account these allowances are directed to. The first would result in placing the three fourths portion in the Allowance Price Containment Reserve Account and the second would result in placing it in the Auction Holding Account.

- Change Section 95831 subparagraph (b)(4)(C) to "Into which three fourths of the serial numbers of allowances submitted to fulfill an entity's untimely surrender~~excess emissions~~ obligation pursuant to Section 95857(a) through (c)~~(d)~~ will be transferred; and" and change §95857(d)(1)(A) to "Three fourths to the Allowance Price Containment Reserve~~Auction Holding~~

Account; and" [Note: Untimely surrender obligations are surrendered pursuant to Section 95857(a) through (c); (d) specifies what the Executive Officer will do with them once they are surrendered.] *Or*

- Move Section 95831subparagraph (b)(4)(C) to Section 95831 paragraph (b)(2) as (b)(2)(D) and change the language to "Three fourths of allowances used to fulfill facilities' untimely surrender obligation pursuant to Sections 95857(a) through (c), as described in~~Into which the serial numbers of allowances submitted to fulfill an entity's excess emissions obligation pursuant to~~ section 95857(d)~~, will be transferred; and~~"

Section 95850: General Requirements

An emission violation is based on the reports submitted by the verification body and reporting entity. We recommend that the regulation, to the extent possible, prohibit the execution of indemnification agreements between the program participants and the verification/reporting agencies. In order to establish a foothold in the program, it is foreseeable that reporting agencies might offer or facilities might demand indemnification agreements which will provide that, in the event that a violation is established through one of their reports, the reporting agency will bear the penalty. This will dilute the incentive for program participants to accurately report their emissions and may result in the concealment of information from the verification body.

Section 95852.2: Emissions Without a Compliance Obligation

The changes to this section appear very significant and may amount to a large amount of potential emissions. In particular, exclusion of landfill methane emissions may result in large additional amounts of greenhouse gases. The rule now appears to entirely exclude any SF6 emissions, even though SF6 is still listed as a regulated pollutant.

Section 95856: Timely Surrender of Compliance Instruments by a Covered Entity

Regarding paragraphs (d)(1) and (d)(2), the previous rule version had six weeks after the end of each year or compliance period to surrender compliance instruments. The proposed changes now give five or seven months, depending on when the facility submits its greenhouse emission reports. We have previously commented that a three year compliance period makes it more difficult to find and enforce against situations where not enough emissions were reported and/or not enough compliance instruments were surrendered. Extending the deadline for surrendering compliance instruments for this long is not necessary. RECLAIM has a 60 day year-end compliance reconciliation period which works well. There will not be adequate incentive for a facility to retire compliance instruments in a timely fashion if five or seven months are allowed. In addition, this length of time may encourage market speculation as a means by which to "time" coming into compliance. Compliance instruments can be surrendered before verification occurs, and then adjustments can be made, if verification results in a change to the reported emissions.

Section 95857: Untimely Surrender of Compliance Instruments by a Covered Entity

Making up excess emissions at a 4:1 ratio is a good deterrent, however, the rules are structured so that this is not due until five days after the next auction or reserve sale conducted by CARB. This presumes

that these will be the only mechanisms for market participants to obtain compliance instruments and may introduce unnecessary delays in obtaining the make-up compliance instruments. We suggest that the excess emissions be due in 30 days, and then appropriate additional enforcement action can be taken for delays.

Regarding paragraph (b)(4), an untimely surrender obligation is due within five days of the first auction or reserve sale conducted by ARB following the applicable surrender date, whichever is later. We recommend whichever is earlier, instead of later.

The provision in subdivision (c) appears to mean that if an entity with an untimely surrender obligation in fact satisfies that obligation, then it will not be subject to any additional civil or criminal penalties for the untimely submittal of its original compliance obligation. This provision may provide insufficient deterrence and may lead to a facility deliberately failing to comply in a timely manner while compliance instrument prices may be relatively high and postponing its obligations until later, when prices may be lower. In RECLAIM, we have seen prices drop dramatically after the conclusion of the reconciliation period. The price differential may be enough to make up for the obligation being multiplied by four times. We recommend retaining the ability to impose civil or criminal penalties for untimely surrender.

Staff supports the deletion of paragraph (c)(6) that would have precluded enforcement action if the untimely surrender obligation was not met in 30 days. CARB should retain discretion to handle such matters on a case-by-case basis.

Section 95858: Compliance Obligation for Under-Reporting in a Previous Compliance Period

In subdivision (a) we are concerned that the provision of a five percent "free" under-reporting will introduce a potentially significant failure of the market to reach its required goals. The Mandatory Reporting rules also allow up to three percent of emissions (up to 20,000 MT CO_2e) to be considered "de minimus" with less rigorous reporting requirements, which also compounds this potential problem.

The formula in the rule does not represent an adequate deterrent against under-reporting. Under-reported emissions should also be made up at a 4:1 ratio, if a shortfall occurred, regardless of whether it was from under-reporting or not surrendering enough compliance instruments to cover reported emissions. Six months is also too long to make up the shortfall. This should be shortened or left to CARB discretion considering the amount of emissions due.

In subdivision (c) it is unclear why "subsequent" year compliance instruments are usable for correcting under-reporting, when they are not usable for the original obligation. This could encourage facilities to deliberately under-report emissions. At a minimum, we suggest that the "subsequent" years be limited to the year in which the under-reporting obligation is being satisfied.

Section 95910: Auction of California GHG Allowances

Paragraph (a)(1) states that the first auction will be held on August 15, 2012 which is before these rules will be considered by the CARB Board.

Subparagraph (c)(2)(A) states that at each auction in 2012, one-half of the allowances designated for advance auction will be from the 2015 budget. It was our understanding that program participants could consign their own allowances for auction. If so, then what happens if they consign allowances from future years in a way that prevents one-half of them from coming from year 2015?

Section 95912: Auction Administration and Registration

Subdivision (e) prohibits a registered entity from communicating "information on auction participation" with any other entity. This appears to be quite broad. We suggest identifying what kind of information may not be communicated, and specifying that information may be communicated to an entity authorized to obtain such information for law enforcement purposes. For example, a District Attorney may be investigating possible collusion of fraud.

Regarding subparagraph (c)(2)(D) and paragraph (b)(3), the standards for approving an auction registration should be defined explicitly, including the criteria for consideration of "any previous or pending investigation with respect to any alleged violation of any rule, regulation, or law associated with any commodity market or exchange" in the decision to approve or deny.

Regarding paragraph (d)(2), has consideration been given to an exemption for the case of a change occurring less than thirty days prior to an auction? Perhaps "An entity approved for auction participation must inform the auction operator at least 30 days prior to an auction when reporting a change to the information disclosed or no more than two days after the change occurs, whichever is later, otherwise the entity may not participate in that auction." Without such an exemption, there is the possibility that an unavoidable change occurring at an inopportune time could result in a compliance problem for a covered entity or opt-in covered entity.

Section 95913: Sale of Allowances from the Allowance Price Containment Reserve

In subdivision (e), it is likely that there will be participants in Reserve auctions that will request bids at multiple tiers with the caveat that if a bid is accepted at a lower-priced tier that the bid(s) at higher-priced tiers be inactivated. Section 95913 paragraph (e)(1) should explicitly allow or explicitly disallow this type of bidding. If it is allowed, section 95913 paragraph (e)(2) should include a provision for the bid guarantee in such cases to adequately cover the most expensive potential result rather than the sum of all bids (*e.g.*, if bids are placed at three tiers but a maximum of two bids are to be accepted, then a bid guarantee in the sum of the two highest bids would be sufficient).

This provision in subparagraph (f)(3)(B) specifies the procedure for selling remaining allowances at one tier level to bidders at the next higher tier level, but does not specify if such sales are to be made, which prices will be used. The provision should explicitly state if the price of the tier from which the allowances remain or the price from the higher tier from which bidders are randomly selected applies to the sale of such allowances.

Section 95914: Auction Participation and Limitations

We are not sure if there is any provision for appeal of the EO's decision to exclude violating participants from future auctions. Perhaps the Executive Officer's discretion can be limited so it will not be arbitrarily executed by defining what punishment is proportional to the violation.

Regarding subparagraph (d)(4), the intent of the phrase "to entities that are not subject to exclusion pursuant to Section 95914(d)(1)" is unclear because Section 95914 paragraph (d)(1) identifies information that entities approved for action participation may not disclose but does not identify any entities that are or are not subject to exclusion. Any exceptions to the disclosure prohibitions of paragraph (d)(1) should be explicitly stated.

We recommend the following changes to subparagraph (e)(2)(C): "Each associated entity's allocated purchase limit share times the auction purchase limit~~number of allowances being auctioned~~ becomes the purchase limit for that entity." Existing language would allow a group of entities with a disclosable corporate association to purchase all allowances available at an auction rather than collectively limiting them to the auction purchase limit, contrary to Section 95911 paragraph (c)(1).

Section 95921: Conduct of Trade

Subparagraph (a)(1)(A) addresses how transactions are reported. What would happen if a transaction is reported later than three days of settlement of the transaction agreement? The language suggests that it will not be registered because the deadline was not met. We recommend that a penalty be assessed instead of not registering the transaction.

In paragraph (d)(3), it is not clear why the accounts administrator has to keep confidential the information concerning the amount and serial number of instruments in an entity's holding account. This would appear to allow manipulation in the secondary market since no one will know who actually has compliance instruments to sell.

We recommend the following changes to paragraph (e)(1): "A trade in which the parties to a transaction reported to the accounts administrator fail to disclose the ownership interest of a registered account holder in the sale or purchase of a compliance instrument before~~until after~~ a transaction is recorded by the accounts administrator". The existing language would not prohibit a trade in which the parties do not report an ownership interest at all.

Subdivision (f) defines the actions that may be taken if an entity violates any provision of this article. The actions are quite broad, and it seems there should be some requirement to preclude arbitrary enforcement, such as some kind of proportional requirement, and some provision for appeal.

Section 95973: Requirements for Offset Projects Using ARB Compliance Offset Protocols

Early offsets can include offsets before December 31, 2006. Is there an estimate (or limit) on the number of these early offsets that can be allowed? This recognizes very old offset projects, and could diminish on-site reductions from covered entities.

Section 95975: Listing of Offset Projects Using ARB Compliance Offset Protocols

Paragraph (c)(5) requires an Offset Project Operator to disclose issued credits by any mandatory or voluntary program for the same offset project. Why shouldn't the Offset Project Operator be prohibited

from claiming any offsets for such "already used" reductions, rather than simply being required to disclose them?

Section 95975: Listing of Offset Projects Using ARB Compliance Offset Protocols

Paragraph (l)(1) defines a limited waiver of sovereign immunity by a tribe seeking to list offsets, or for projects located on specified lands. The waiver does not include consent to criminal prosecution and perhaps it should.

Section 95977.1: Requirements for Offset Verification Services

Subclause (b)(3)(D)(2)(h) prohibits a project from receiving CARB offset credits or registry offset credits if it does not meet the requirements of Section 95977.1 subclause (b)(3)(D)(2)(f) regarding compliance with local, state, and federal environmental laws. This prohibition should apply to a project that does not meet any requirement of the cap and trade rule.

Section 95979: Conflict of Interest Requirements for Verification Bodies for Verification of Offset Project Data Reports

We appreciate the inclusion of the language that clarifies that many of the routine regulatory duties do not constitute a high conflict of interest for air district verification staff.

Paragraph (g)(3) provides special provisions for air districts serving as offset verifiers. It states that if an air district hires a subcontractor who is not an air district employee, then the air district shall be subject to all the requirements of Section 95979. This should be changed to "the subcontractor" shall be subject to all those requirements.

Section 95981.1: Process for Issuance of ARB Offset Credits

Paragraph (d)(4) appears to say that the Executive Officer's decision to deny issuance of CARB offset credits is "final." This should be clarified to state "subject to judicial review."

Section 95985: Invalidation of ARB Offset Credits

In subdivision (h), the reference to not precluding the "State of California" from taking enforcement action should be broadened to include any entity authorized by law to enforce the provisions of this regulation.

Section 95987: Offset Project Registry Requirements

Subdivision (e) has been changed to require ten percent of the annual offset verifications to be audited by a registry. The version adopted in December 2010 had 20 percent offset verifications. Since offset quality is critical to program success, we would recommend keeping the higher audit requirement.

Section 95990: Recognition of Early Action Offset Credits

Subparagraph (a)(2)(B) requires an Early Action Offset Program to have a system for tracking ownership and transactions of all offset credits it issues at all times. It is not clear if this means including the secondary market. This may not be reasonable.

Paragraph (a)(3) requires that the program's primary business be operating as an offset registry, and prohibits it from offering any verification services. We have previously requested an exception for air districts from these requirements.

The perjury section in paragraph (a)(6) should say "under penalty of perjury under the laws of the State of California".

Section 96014: Violations

Section 96014 has been modified to delete the catch-all requirement that "each day or portion thereof in which any other violation of this Article occurs is a separate offense." We strongly recommend this language be reinstated. As currently proposed, section 96014 recognizes only two types of violations: failing to submit sufficient compliance instruments, and submitting any false document or one omitting a material fact. There are potentially many other violations of the program that should be subject to penalty. For example: participating in the program without having registered with CARB, failure to provide records requested by CARB, failure to comply with the six-year rotation requirement; failure to retire offsets used as CARB offsets, etc. CARB needs to maintain the ability for civil and criminal prosecution of any violation of the program.

In addition, the rule establishes violations in two ways. First, a separate violation is based on each compliance instrument that has not been surrendered in accordance with the program requirements. As noted in the comments to Section 95858, we do not support having no compliance obligation for up to five percent under-reporting. If this is not changed we suggest the following. Because there is no violation unless the five percent threshold is exceeded, program participants will argue that the number of violations is limited to the number of compliance instruments which exceed five percent. The rule should make it clear that, once the five percent margin is exceeded, every compliance instrument, even those within the five percent margin, will be counted as the basis for a separate violation.

The rule also establishes a separate day of violation for each day after the reporting period. In many cases, this will result in a relatively small number of days of violation. The Health and Safety Code is based on actual days of violation (as opposed to pounds of pollution or numbers of compliance instruments), so this provision is of critical importance. If an enforcement action is taken to court, the extent to which actual days of violation can be established will be persuasive to a judge. Accordingly, in order to ensure adequate deterrent value in cases which may be based on negligent or intentional conduct, we recommend that the rule provide that a separate day of violation is established for each day of the applicable compliance period unless the program participant can establish compliance for each of those days. The violations continue until final compliance is achieved. This will provide an adequate number of days of violation to deter future misconduct at the facility and throughout the regulated community.

We endorse the provisions which specify the reporting violations. We are concerned, however, that the emphasis on deliberate, intentional, fraudulent reporting dilutes the impact of the strict liability offense of simply submitting an inaccurate report. Our experience has shown that most cap and trade violations will be based on inaccurate and/or untimely reporting. It is extremely difficult to establish that the inaccurate reports were the product of fraud or trickery. It is imperative that the program participants know that inaccurate and untimely reporting may be subject to the highest penalties authorized by law.

Section 96022: Jurisdiction of California

Section 90622 has been modified to attempt to ensure that all program participants are subject to the jurisdiction of California. Similar language is included in a number of places where the participant is required to certify that he or she consents to that jurisdiction. We suggest that the language in Section 96022 and other certification sections be broadened to ensure that participants are subject to (1) service of process in California (by requiring them to designate a registered agent for service of process); (2) choice of law (i.e. disputes will be governed by California law); and (3) jurisdiction and venue in California (may prefer that for out-of-state participants, venue will be in Sacramento). Language accomplishing these three purposes is contained in SCAQMD's RECLAIM Rule, which may be adapted for this purpose. Below, please see an excerpt from SCAQMD Rule 2007(e)(2)(J).

> (J)(2) A buyer or seller who is not a RECLAIM Facility Permit holder and who is not domiciled in the State of California shall submit contemporaneously with the filing of the Registration of RTC Transfer, or have on file with the District:
>
> (i) written proof of appointment of a licensed Agent for Services of Process within the State of California with such appointment being effective for at least an additional four years after the most recent trade, in a manner and form specified by the Executive Officer;
> (ii) written consent that, in the event of any dispute regarding any purchase or sale of RTCs, the transaction and the resolution of any related dispute, claim or prosecution shall be governed by the laws of the State of California, and;
> (iii) written consent that the Superior Court of the State of California, County of Los Angeles shall have jurisdiction and shall be the proper venue for any legal proceeding relating to any sale or purchase of RTCs.

II. Air District Participation in Implementing the State Cap and Trade Program

SCAQMD and CAPCOA have consistently raised several issues regarding how local air districts can help facilitate compliance for AB 32 requirements and the appropriate roles and responsibilities for air district participation. These items remain unresolved. The CARB adopting Resolution for the December 2010 public hearing included the following commitment (page 13):

> *BE IT FURTHER RESOLVED that the Board directs the Executive Officer to establish a Board-member facilitated dialogue with the California Air Pollution Control Officers Association regarding involvement of the air pollution control and air quality management districts (air*

districts) in the implementation of the cap-and-trade regulation, development of compliance offset protocols, and other AB 32 programs.

Unfortunately, this process has not occurred. At the May 4, 2011 CAPCOA Board meeting, Mr. Goldstene requested that the meeting with Ms. Berg be postponed to allow CARB staff the opportunity to work with CAPCOA. However, no meaningful discussions with CAPCOA have occurred, and the proposed rule changes do not address most of the issues that CAPCOA has raised regarding air district assistance in implementing the cap and trade program. The following sections of this letter briefly reiterate these discussion items.

Ability to Perform Multiple Roles

The proposed rules do not address the ability for air districts to perform multiple roles in the cap and trade program. Section 95986 (d)(3) still contains restrictions that an organization cannot perform multiple roles. As detailed in previous correspondence from CAPCOA and in briefing materials prepared by SCAQMD staff for Secretary Linda Adams (November 9, 2010) and Ms. Nichols (December 9, 2010), SCAQMD supports the previously requested language from CAPCOA. This language is included below:

> Section 95989. California air pollution control districts or air quality management districts Notwithstanding any other provision of this regulation, California air pollution control districts or air quality management districts may be approved for multiple roles, including verification for mandatory reporting or offsets, holding compliance instruments, implementing offset projects that are verified by a third party and approved by CARB, and running a Registry, provided the appropriate training, certification, or approvals are obtained from CARB. Decisions on such approval requests will be provided in a timely fashion.

Ability to Run a Registry

SCAQMD may wish to run an offset registry, but this is currently precluded in Section 95986, which has a requirement that to be an Offset Project Registry, it must be the organization's primary business. Further, an organization that runs a registry cannot do many other functions related to offsets, such as run projects or verify offsets.

Holding Compliance Instruments

Section 95814 paragraph (b)(1) would prevent air districts serving as a verification body or as an offset verifier from holding compliance instruments. This should be allowed for air districts, as holding a small amount of compliance instruments may be needed for insurance purposes for verification services.

III. Comments on Portions of the Rule that are not 15-day Changes

Even though these portions of the rule are not part of the 15-day changes, we remain concerned about these sections and have some specific recommendations for CARB to consider.

Section 95820: Compliance Instruments Issued by the Air Resources Board

The rule language in subdivision (c) should allow the Board, as well as the Executive Officer, to terminate or limit the authorization to emit represented by a compliance instrument.

Section 95921: Conduct of Trade

We recommend the following change to paragraph (e)(1): "A trade in which the parties to a transaction reported to the accounts administrator fail to disclose the ownership interest of a registered account holder in the sale or purchase of a compliance instrument before~~until after~~ a transaction is recorded by the accounts administrator" The existing language would not prohibit a trade in which the parties do not report an ownership interest at all.

Section 95922: Banking, Expiration, and Voluntary Retirement

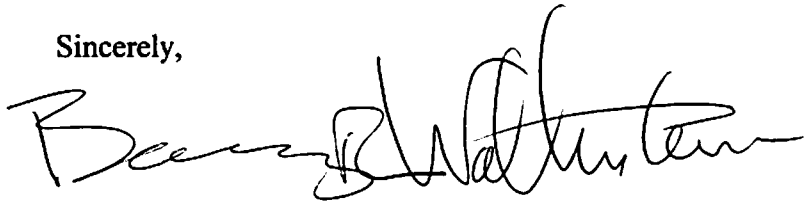
We have previously commented that unlimited banking could have the unintended consequence of the program not meeting the 2020 emissions goal. Provisions need to be added to limit the number of banked compliance instruments or the time that they can be banked. With the economic downturn it is likely that many facilities will be able to bank unused compliance instruments in the early years of the program and may not need to use them in the future. This may also lead to price fluctuations in the market. For example, in the last compliance period, if large amounts of banked compliance instruments are offered for sale, the price could drop dramatically which would limit the amount of on-site reductions made by facilities. This may make it even more difficult to achieve the transformative changes that will be needed to meet the 2050 greenhouse gas emission reductions target for the state.

Section 95850

For subdivision (c), we recommend that the most recent records be available on-site and be required to be produced to the Executive Officer "on request." If you allow 20 days for the production of any records, it allows the source plenty of time to forge nonexistent records. Making a "surprise" demand provides for better enforceability.

Thank you for the opportunity to provide these comments. Please feel free to contact me if you have questions about this information or if SCAQMD staff can be of service.

Sincerely,



Barry R. Wallerstein, D.Env.
Executive Officer

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cc: CAPCOA Board Members
(brwcapandtradeletteraugust20112)