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

IETA COMMENTS ON CALIFORNIA'S CAP ON GREENHOUSE GAS EMSSIONS AND MARKET-BASED COMPLIANCE MECHANISMS

On behalf of the International Emissions Trading Association (IETA), I am grateful for the opportunity to provide comments, as part of the Second Notice of Public Availability of Modified Text, to California's *Draft Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms* and the second Proposed 15-day Amendments, established pursuant to subchapter 10 of the California code of regulations. I hope that ARB considers IETA's perspectives and insights as it moves forward with implementation.

IETA extends its appreciation to California for its continued leadership in developing a cap-and-trade program as a principal component of its efforts to reduce greenhouse gas emissions across the state and the Western Climate Initiative (WCI). A well-designed and executed emissions and offsets program, which builds off valuable experiences and lessons learned from existing environmental markets, will help the state cost-effectively reach its climate commitments, as well as maintain California's growing international reputation as a low-carbon policy leader and competitive hub for green investment and job opportunities.

INTRODUCTION

IETA is a multi-sector business association with a common interest in harnessing the power and flexibility of markets to address the climate challenge and drive low-carbon solutions at least cost to society and businesses. For over a decade, IETA has been the leading voice of the business community on the subject of emissions trading, and our 160 member companies include some of North America's, and the world's, largest industrial and financial corporations—including global leaders in oil & gas, mining, power, cement, aluminum, chemical, pulp & paper, and investment banking. IETA also represents a broad range of global leaders from the industries of: data verification and certification; brokering and trading; offset project development; legal and advisory services.

Key stakeholders appreciate that tackling climate change – and driving green investment and industrial development – will remain at the top of policy agendas across North America and globally. With this in mind, the business community, like all sectors of society, will be called upon to make its contribution to reducing greenhouse gases.

IETA is therefore encouraged to see that California remains committed to developing and executing a robust, fair, and fully-functional greenhouse gas allowance market, designed to be easily-linked to other markets' programs and jurisdictions, particularly those involved in the WCI.

KEY OBSERVATIONS AND RECOMMENDATIONS

IETA believes a number of design elements in California's proposed 15-day amendments to the *Draft Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms* could be optimized. We look forward to working with state officials to improve upon the regulations as they are finalized and during the implementation phase, when linking and other processes critical to a successful program will be developed. IETA's submission offers observations and recommendations related to the following items:

I. Improve the circumstances and the process for the invalidation of offset credits;
II. Extend the period of time to which the quantitative usage limit would apply to the full length of the program;
III. Streamline the accreditation process for early action offsets;
IV. Expand on the number of eligible domestic offset project types;
V. Increase holding limits and auction purchase limits, and increase auction frequency;
VI. Reconsider the 10 percent reduction in allocated allowances starting in 2015;
VII. Revise the enforcement provisions for holding limits to ensure the responsibility for correcting a violation rests solely on the entity in violation and not unwitting counterparties.

I. IMPROVEMENTS TO THE CIRCUMSTANCES AND THE PROCESS FOR THE INVALIDATION OF OFFSET CREDITS

PROLOGUE:

IETA has expressed significant concern with the offset invalidation provisions in the cap-and-trade rule. IETA, together with other major industry associations, submitted to ARB a white paper in early May 2011 outlining a broad consensus view regarding the market constraints imposed by these provisions, and proposed a workable solution using a "compliance buffer account" funded by offsets withheld at issuance. The primary concerns of this group – which represents the majority of market participants by both volume and consumer base – relating to the invalidation approach can be found in IETA's August 11 letter submitted in response to the first 15-Day rulemaking package. In addition, the outline of the group's "Compliance Buffer Account" proposal can be found as Appendix 1 to that letter.

We acknowledge and greatly appreciate the attention ARB has devoted to reviewing our efforts and analyzing different scenarios. We realize that ARB staff and officers have integrated significant portions of our collective members' input into their latest rulemaking language, and that they have genuinely worked to offer improved regulation in this area. With those observations as prologue, IETA offers generally positive reactions and has suggested modifications to the conditions and process for the invalidation of offsets.

While we believe we understand the motivations for the implementation of such a rule, IETA respectfully requests the Board give ARB officers and staff the opportunity to explore new consensus during the upcoming implementation phases, and to consider repealing the invalidation rule 95985, so that the use of offsets can achieve its highest potential to contain costs for California's consumers and ratepayers.

CURRENT ASSESSMENT AND READ OF THE INVALIDATION RULE:

IETA members have every desire to work constructively with ARB to ensure that any approach that involves invalidation contains well-defined parameters that will:

- Not be a detriment to investment in projects that meet ARB's requirements for compliance offsets approved for use in California. Offsets projects have great potential to bring capital and expertise from outside the state into California, but the rules as written have hindered investment plans and depressed prices in the market.

- Enable the management of the price risk associated with the potential invalidation of ARB-approved offsets for the California market. Providing the means to better forecast the ways that offsets could become invalidated will give participants greater opportunity to manage the risk.

IETA is encouraged by many of the revisions proposed to Section 95985, and respectfully submits that more specificity is needed for when ARB determines that an offset project performance has been overstated by more than 5% (Section 95985 (c) (1)). While it is not yet clear that the 'yardstick' for the project's performance is the Offset Project Data Report, it also is not clear 1) how the grounds for invalidation can occur, 2) whether it is based on a second verification or 3) if determinations will get made by a generally accepted industry auditor or by a related regulator or another official body.

Regardless of the liability approach ARB adopts, it is important to ensure that the process for offset credit invalidation is well designed. We appreciate the many modifications that ARB added to the invalidation procedures. However, IETA urges the Board to direct ARB to consider further modifications in line with the two parameters above. In that spirit, IETA is pleased to see that ARB has taken actions on the modifications we suggested in our August 11 letter around the following reforms for which we offer additional comments:

1. **Tightening the Limit of the Statute of Limitations to no longer than the Finalization of a Second Independent Verification.** In its earlier language, ARB introduced a statute of limitations of eight years for invalidation of already-issued offset credits with a shortening of the statute of limitations to five years if a project undergoes a second verification after three years of issuance of the credits. We are extremely pleased to see ARB integrate reforms that tightened the time limit to three years for ODS projects and three reporting periods for all other types of projects, but in practice we believe this could still be shortened and in fact eliminated for all but the most extreme circumstances.

   We have noted, as have ARB officers, that the second verification accords a significant "yardstick of credibility;" ARB considers the validity of offset credits sufficiently established and quantified, once the project has been reviewed by a second, independent ARB-accredited verifier and the second verifier has not identified any grounds for invalidation.

   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. Because the second independent verification

is the means by which a credit may be invalidated, a positive or successful second verification logically fulfills ARB's need to confirm and attest to the quality of a credit.

IETA believes this yardstick of credibility is a well-grounded tool for standing by the environmental integrity of issued offsets. Also, it provides a basis for minimizing an otherwise extended period of time during which issued – and "double-approved" for all intents and purposes – offset credits remain subject to invalidation. In particular, we think it would lead many entities buying ODS projects in the offsets market to manage their risk by obtaining a second verification of the data report immediately following the issuance of credits—furthering the credibility of the program. In short, the second verification acts as the de facto insurance for ODS offsets. Although we cannot speculate that insurance products will emerge to manage the risk of validation (whether before and after the second verification), this much shorter period will enable a more manageable time horizon for transactions. The second verification public record will also build a data set that might enable better risk management processes overall. For non-ODS projects, a process to review these projects' Data Reports – analogous to the ARB early action process – by a second independent verifier could convey the same benefit and achieve the same result.

Thus, the second verification provides assurance of the credit quality and an arbitrary delay provides no greater objective assurances regarding its environmental integrity. However, the marketplace will not consider the credit fully valid, and its marketability will be impaired for the length of that period of delay. In addition, it will likely offer the marketplace sufficient certainty to encourage investment in offset projects, ensuring adequate supply of credits for use in controlling the costs of the program.

2. **Elimination of the Condition that Offset Credits may be Invalidated due to Project Information that is not "True, Accurate, or Complete" and in practice to Limit Liability from "Overstatement" to the Extent of the Overage.** In addition, IETA had urged to ARB modify the provisions under which offset credits may be invalidated.

   In the past language, ARB included four conditions defining points for invalidation:

   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)).

   Regarding point 1: IETA is pleased to see the elimination of ((b)(1)). It represented a broad reach of oversight authority beyond discrepancies that would have material effects on the environmental integrity of projects.

   Regarding point 2: IETA is pleased to tightening of the language of regarding the liability once the 5% threshold is exceeded, such that only the difference – i.e. the overstatement beyond 5% - gets invalidated; however as a practical matter, the means by which the "errors in emissions reductions achieved" versus the Offset Project Data Report is calculated needs more clarity. How will ARB make this finding? How will ARB make the calculation? As

a further practical matter (and as cited at the end of our recommendations regarding the statute of limitations, above), this error and quantitative finding could be exposed and assessed in the second validation and that determination could be final. If there were legal issues (e.g. the Verifier or some other party was suspect in some way) around the circumstances of the second validation, then ARB would naturally be the "next judge" to make the finding and subsequent assessment. And of course, if the project did not undergo a second validation, then ARB would be the natural authority for making the finding and quantifying the subsequent invalidations.

Regarding point 3: On the surface, IETA is comfortable with the spirit of capturing illegal activity. The question arises when the wrong codes of laws or regulations are applied to making the determination that illegal behavior occurred; the regulation (c)(2) currently states "…not in accordance with all local, state, or national environmental and health and safety regulations…;" we respectfully ask that at a minimum the regulation say that "all relevant and applicable" instead of just "all," and that ARB Staff narrow this language further to minimize the chance for nuisance claims and the potentially negative legal exposures this current language poses for ARB.

Regarding point 4: IETA is comfortable with this stipulation.

Finally, we extend appreciation for ensuring that an issued credit not become subject to invalidation, in the future, due to a change to the underlying protocol.

3. **Allowing Responsible Entities Six Months to Replace Compliance Instruments.** IETA greatly appreciates that ARB has extended the period of time that a party has for replacement of invalidated credits from 30 days, then to 90 days, and now to six months. The procedures that are outlined in (d) through (j) are quite involved and will need to be supported by the systems employed by ARB by the start of the program.

   Finally in the first instance of an invalidation determination, many market participants believe that it ought to be the responsibility of the project owner or other relevant entity that committed the error (not automatically the buyer as the first instance), to reimburse lost credits due to invalidation. This does not eliminate the ultimate liability of the buyer, and does not change any duties of the regulator. But instead it establishes a clearer chain of claims when appropriate, and puts even more incentive on project owners and investors to initiate and execute projects of the highest environmental integrity in the first place.

II. QUANTITATIVE USAGE LIMIT FOR OFFSETS AND HOW IT APPLIES OVER TIME

California's cap-and-trade draft regulations continue to place an 8% limit on the percentage of offsets available to individual covered entities. IETA continues to support the removal of any quantitative usage limits placed on covered entities for using offsets to meet their compliance obligations. As long as only real, permanent, and verifiable offset credits are allowed into the market, usage limits that are small relative to overall compliance obligations will only serve to constrain investment in reductions of greenhouse gas emissions in a cost-effective manner.

Offsets provide critical cost-containment and price stability by providing flexibility to covered industries to find the lowest available cost emissions reductions across a range of options. For this reason, **IETA continues to recommend that California eliminate the use of quantitative offset usage limits.**

Should California continue to have a quantitative usage limit, IETA – including the voice of some of California's largest compliance entities – continues to recommend that the usage limit apply to an entity's compliance requirement over the program's entire timeframe, currently out to 2020. Currently the usage limit expires with the end of each compliance period and unused capacity cannot be carried over to the next period.

To the extent that a compliance entity does not fully utilize its quantitative offset limit, the absolute number of "unused" offset credits would be calculated and carried over to the entity's next compliance period. So, assuming the 8% rule applies, in the subsequent compliance period, a compliance entity's ability to use offset credits would equal 8% of "new" emissions during the compliance period, plus the absolute number of unused "carryover" credits from the prior period. Similarly, in all subsequent compliance periods, actual offset credits used would be subtracted from the "theoretical" offset credits allowed, for each entity, and that new absolute number would be the "carryover" for the next period, and so on, in perpetuity – so if the program were to carry on beyond 2020, unused offsets' compliance potential would not be foregone forever.

To illustrate:

If total period one (2013-2014) emissions is 1,000,000:

Theoretical offset credits allowed is 80,000 (8% x 1,000,000)
Assuming actual offset credits used for the first compliance period is 53,000
"Carryover" for the future compliance periods is 27,000 (80,000 - 53,000)

If total period two (2015-2017) emissions is 800,000:

Theoretical offset credits allowed is 64,000 (8% x 800,000)
Theoretical plus carryover is 91,000 (64,000+27,000)
Assuming actual offset credits used for the second compliance period is 74,000
Carryover to period three (2018-2020) is 17,000 (91,000 - 74,000)

Should the quantitative usage limit remain in place, IETA strongly recommends the inclusion of an administratively fair "carryover" by entity to the next compliance period provision for the full length of the program — eight years or from 2013 to 2020.

III. STREAMLINE THE ACCREDATION PROCESS FOR EARLY ACTION OFFSETS

IETA notes that ARB has modified its 95990(d) rule to also allow "holders" of early action credits to register with ARB. We are pleased to see ARB expand this provision to include "holders" in case there is no interest or incentive to do so on the part of the project operators or authorized designees. However we do want to echo comments submitted on August 11, 2011 to ARB's modified text for the proposed California cap-and-trade program rules, as IETA still has concerns

that the process for accrediting early action credits and transitioning them to ARB-certified offsets continues to be unreasonably burdensome.

Specifically, New Sections 95990(h)(6)(A), (B), and (C), still require the Offset Project Operator, Authorized Project Designee, or each holder of the early action credit seeking issuance of ARB offset credits to cumbersome processes for attestations. Again, while IETA understands these sections relate to ARB efforts to make early action offsets undergo consistent post-issuance provisions compared with compliance offset credits, holders of early action offsets cannot make the attestations outlined as these elements are beyond their control; and they will need to come under the purview of the original project verifier and ARB appointed verifier instead.

IETA also notes the ARB provided additional clarification to the provisions dealing with the conversion of forestry offsets to ARB early action offset credits. The newly modified draft rule, however, still does not identify a mechanism for how additional protocols will be considered and added to the list of existing eligible early action methodologies. To truly facilitate the development of an adequate pool of early action credits, IETA again suggests more clarity must be provided for how these early action protocols can be brought forward for consideration and approval.

IETA recommends ARB amend Section 95990 to include provisions for a transparent process that ARB will employ to consider, evaluate and approve additional early action offset protocols.

IV. EXPAND ON THE NUMBER OF ELIGIBLE DOMESTIC OFFSET PROJECT TYPES

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 commends ARB for providing some guidance on three additional protocols, and also providing notice that it will suggest further protocols for review at the Board meeting in October. IETA has concerns that there will be offset supply shortages if the current project types are not increased and, in the short-term, about the infrastructure being in place to enable offsets from early-action projects to come to market as quickly as possible. IETA also has concerns about the transparency with which new offset protocols are assessed and announced. Without additional protocols, a timeline for infrastructure development and a more transparent process for new protocols being considered the market will not be able to provide sufficient supply when needed 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 and the Gold Standard. Recognizing existing projects will help to create a greater initial supply of offset credits for the market.

2. **The provision of timelines for the development of offset market infrastructure.** ARB has specified the timing for auctions in 2012 but has not provided any timelines for the registration of early action offset projects. A definitive timeline would help all parties to better plan and contract for offset deliveries and allow time to identify and resolve any bottlenecks in the approval process

3. **The reorganization of offset credits from ARB-approved offset programs.** In addition to expanding early action offset protocols, 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 official path or 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.

V. AUCTION PURCHASE LIMITS, HOLDING LIMITS AND AUCTION FREQUENCY

IETA generally does not support the adoption of auction purchase limits or holding limits. Such measures are difficult to enforce effectively and can actually impede the proper functioning of a cap-and-trade program, particularly in relation to curbing the risk of market manipulation or market power. Experience with carbon markets in other jurisdictions around the world demonstrates that the frequency of allowance auctions is in fact the most effective tool in addressing market power issues. In order to deliver the full benefits of the market to consumers, the program should avoid auction or holding limits that reduce liquidity by unnecessarily constraining participation from either covered entities or other liquidity providers, such as non-emitting investors and entrepreneurs. As the California electricity crisis demonstrated, government attempts to force markets to behave in a given manner, while well-intentioned, can yield unintended consequences.

1. Auction Purchase Limits

IETA would like to thank the ARB for increasing the purchase limits for covered entities from 10 percent to 15 percent for current vintage allowances, in Section 95911(c)(4)(a). IETA believes this change is an improvement. However, IETA believes it only solves part of the problem.

The use of auction purchase limits can have the unintended consequences of both restricting liquidity and creating an unlevel playing field between entities. Companies with a large compliance obligation will require more annual allowances than the purchase limit at a quarterly auction. This could increase the potential for price manipulation and price spikes by limiting a company's ability to sit an auction out if prices are excessively high in

that particular auction. In addition, such companies would have limited ability to buy allowances to sell in the secondary market, which could further reduce liquidity. Finally, this policy could create a situation where some compliance entities are forced to purchase allowances in the secondary market instead of at auction—likely with a markup reflecting the sellers' leverage in the market.

IETA re-iterates our request that the purchase limits be revised further in order to increase liquidity and create a level playing field for all entities. IETA recommends that all covered entities be allowed to purchase an amount equal to the greater of either a) the auction purchase limit; or b) their compliance obligation plus the current proposed 4% granted to non-covered entities.

2. Holding Limits

IETA understands that ARB views an allowance holding limit as a mechanism to reduce the possibility of a market participant exercising allowance market power. However, holding limits are likely to prove ineffective in this regard, and may create unintended consequences because they will severely limit market liquidity, thus creating conditions that could allow certain entities, including speculators, to exert undue market power in an illiquid trading environment.

The potential for price manipulation and the exercise of market power is greater in illiquid markets, even if a quantitative restriction on holding permits prevents a single entity from acquiring undue market share. This is due to the fact that non-covered entities and other market participants can gain the ability to shape prices in secondary allowance markets and collect unnecessary economic rents through a markup. This incentive for gaming is particularly applicable to large entities with small compliance limits, as they can hold permits above their compliance obligation but below the holding limit, giving them the potential to exert market power over larger entities with more limited flexibility.

Furthermore, with these limits in place, larger covered entities will face greater pressure to participate in all auctions regardless of price conditions. They have limited ability to hold allowances to offset this price risk, and are unable to then provide allowances back to the market when the market is short. This inflexibility will raise the compliance cost for these entities, which will be passed on to ratepayers. Counterparties in these transactions can, at the same time, extract economic rents from selling allowances for a markup to large covered entities forced to purchase.

Based on the aforementioned arguments, IETA continues to recommend that holding limits be discarded. If holding limits are retained, IETA recommends that at a minimum they be adjusted to reflect, in addition to the amounts held in non-trading compliance accounts, the greater of either:

a. The holding limits currently proposed in 95920 or
b. A quantity equal to a covered entity's compliance obligation.

3. Auction Frequency

Currently, the program provides for quarterly auctions, which runs contrary to recent research and analysis conducted on the management of carbon market auctions in Europe. Based on this research and recent experience in carbon markets, the European Union requires that all auctions be conducted weekly or more frequently, commencing in 2013. Infrequent auctions create price volatility and prices spike in anticipation of upcoming auctions. Holding more auctions smoothes this volatility by permitting more frequent transactions to take place. Additionally, price discovery is a key component to a functioning marketplace, and therefore if more auctions take place then more accurate price signals are transmitted.

IETA reiterates its recommendation that purchase limits and holding limits be replaced with more frequent auctions, for example on a monthly basis.

Based on recent experience, many will point to RGGI's quarterly frequency and bidding rules as a relatively simple and straight-forward auction design, which is well understood and accessible to a host of entities. While a quarterly auction might be appropriate for small jurisdictions with low demand, IETA believes the implementation of a quarterly auction schedule becomes inconsistent with recent research and analysis conducted in connection with the management of allowance auctions in the EU ETS. Based on said analyses, starting in 2013 the EU requires that all regional allowance auctions be conducted on a weekly basis (if not more frequently). The European Commission's decision to hold frequent auctions was driven by the large volume of allowances going to auction in the future, as well as the desire to curb potential price spikes, price volatility, and opportunities for market manipulation.

In light of the above, California officials might want to consider timing the frequency of its allowance auctions based on the number of allowances to be auctioned over each period. Weekly auctions are likely to work well in jurisdictions with a large pool of allowances, such as the EU ETS; however, in jurisdictions with constrained coverage and/or large gratis allocations, weekly/monthly auctions could exhibit such small available volumes as to make auction participation high-cost with relatively low-value. IETA welcomes the opportunity to meet with officials to discuss auction design, frequency options and trade-offs.

VI. 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. In a more recent development, the draft regulation now includes significant additional reductions in allocation to industrial entities, through the benchmarking design approach, starting on day one of the program.

This recently enacted 10% " haircut" significantly increases the compliance obligation for the industrial sector early in the program – and runs counter to the very carefully thought-out and justified "soft start" to the program. At this rate, industry will find it very difficult to adjust to the increased costs of auction, threatening competitiveness, and jobs, and impacting consumer energy

prices, and potentially affecting public support for the program. Simply put, allocating allowances helps to minimize leakage and prevent California industries from being put at a competitive disadvantage.

It is important to keep in mind that for companies who have been designated as trade exposed, free allocation of allowances is a way to mitigate their exposure and to lessen the impact of a transition to a low carbon economy. With input from the Governor's office, ARB has concluded that free allocation of allowances, especially early in the program, is necessary and warranted, and has as a result provided for a transition period. Therefore, when considering a method to distribute these free allowances, it is important that the method chosen and the design elements of that method do not run counter to the intentions of freely allocating allowances.

Of most concern in this regard is the intention to reduce initial allocation by 10% (either through the benchmarking process or in other ways) – which is suggested by staff to be necessary in order to fund various accounts or programs. This is a significant reduction in allocations and it would increase compliance obligations for affected regulated parties by 250% (from 4% to 14%) in the first compliance period – this increase being in a period that had been designed as providing a "soft start" and transition period for regulated entities.

The justification for, and design of, a "soft start" to the cap and trade program was very carefully considered in the earliest scoping discussions for Cap-and-Trade. The need for a soft start was clearly articulated by then Governor Schwarzenegger and subsequently affirmed by ARB leadership and their Board. The upshot was a policy of full allocation in the first compliance period to sectors determined to be trade exposed. To the contrary, the current rules do not square with that determination, so it is very inconsistent for there to be such a significant reduction in first compliance period allocation with the resulting 250% increase in the compliance obligation at the outset of the program, as highlighted above.

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 removed, and that the regulation adheres to the concept of a soft start. 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.

We strongly urge ARB to rescind any consideration of a reduced allowance allocation (or "haircut" as it has been referred to). The use of the first compliance period should continue to be viewed as a period that while it will deliver real, tangible emission reductions, allows regulated parties to transition to a low carbon economy.

VII. CONDUCT OF TRADE

IETA believes the regulatory provisions within Section 95921 ("Conduct of Trade") provide an important structural foundation for the California carbon trading market. In previous comments to ARB, IETA expressed serious concerns with language under this section, and the Secretariat sought to illustrate the impacts they would have on the functioning of the market. IETA recognizes that significant changes to this section have been proposed in the latest round of 15-day rule changes,

and these changes are largely positive. However, we continue to have concerns on this Section's impact on carbon market development. Comments on specific provisions follow:

a. Transfer of Compliance Instruments

ARB proposes changes to this section which apply rules on the conduct of trade to transfers of compliance instruments, rather than "transactions." IETA welcomes this clarification, as we believe it would have been impractical for ARB to regulate the underlying transactions in a future carbon market. A carbon market that consists of a combination of spot, forward, future, and options transactions would make interpreting the positions of market participants relative to their holding limits difficult, if not impossible.

Furthermore, requiring a review of every market transaction by ARB would have had a significant negative impact on market liquidity. As IETA has asserted previously, a lack of liquidity in the market can result in higher transaction costs and higher costs of compliance.

IETA has reservations regarding the authority of the ARB Executive Officer to reverse transfers of compliance instruments. Markets underlying the cap-and-trade program rely on the certainty of transactions, in which the transfer of compliance instruments is completed based on agreed upon terms and cannot be reversed. IETA understands ARB's need to create a mechanism for the enforcement of the holding limit and to ensure compliant requests for transfer of compliance mechanisms. However, reversals of non-compliant trades could result in market disruptions that, again, are likely to restrict market liquidity.

IETA recognizes, however, that ARB has proposed significant changes to this section to allow for a cure period in the event of deficient transfer requests. The ability for transferees to correct deficient transfer requests within three days of notification of the deficiency (and within five days in the event of a retroactive notification) is a considerable improvement. Previously, ARB only had the authority to reverse trades, which would have forced entities to automatically unwind trades in the event of a deficiency. This would result in the market disruptions described above.

Although the current draft of this section is an improvement, IETA believes a host of unintended consequences could result from ARB's ability to reverse trades in instances of transfer requests that exceed an entity's holding limit. As IETA has stated previously the reversal of a transfer could result in a daisy chain of entities exceeding holding limits stemming from counterparties forced to take back transferred allowances.

More importantly, the ability of a regulator to reverse trades undermines the core tenant of markets that trades cannot be reversed. The result could be a lack of confidence in the California carbon market and the inability of regulated exchanges and other trading venues to develop the infrastructure necessary for a transparent and fair market. This is perhaps why we are not aware of another cap-and-trade program existing that provides its regulatory such trade reversal authority.

This authority also provides an opportunity for gaming of the market. For instance, an entity taken over its holding limit by an allowance transfer could use ARB's reversal authority to have allowance purchases reversed that it believes are outside of its commercial interest. For instance, the entity could choose to allow ARB to reverse a trade that is out of the money, thereby using regulatory powers to financial benefit.

Therefore, IETA recommends ARB eliminate the transfer reversal authority from the regulations. Instead, ARB can retain the new language providing for a cure period, and at the end of the cure period impose a penalty pursuant to section 96013 should the entity not reduce its holdings to below the holding limit or rectify a deficient transfer request.

b. Market Oversight

Section 95921 (e), "General Prohibition on Trading", in part, casts ARB in the role of market regulator by prohibiting trades that attempt to mislead or manipulate the market. ARB has stated that it will rely on federal oversight of futures and swaps trading markets under the Dodd-Frank Act, which is now being implemented by the Commodity Futures Trading Commission. However, ARB seeks to fill the gaps in regulation by overseeing the spot and forward trading markets.

IETA offers that effective and efficient regulation of environmental trading markets is essential to market confidence and, ultimately, their ability to assist in meeting stated environmental objectives – such as reducing concentrations of greenhouse gases. Overly restrictive market regulation or lack of proper oversight can have the same negative impacts. Therefore, getting market regulation right is essential.

IETA is concerned that ARB does not have the proper expertise or resources to effectively oversee the trading market, particularly the forward transaction market. As an environmental regulatory body, ARB has responsibility for environmental compliance, but has not previously overseen a trading market corresponding to these environmental programs.

ARB has recently published requests for proposals for an independent market monitor and market monitoring staff training. These are important programs, but only part of the regulatory resources needed to effectively oversee markets. IETA encourages ARB to seek, and the California State Legislature and Brown Administration to provide, the proper level of resources to properly oversee markets. IETA also encourages ARB to continue its close collaboration with the CFTC.

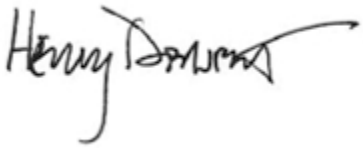
Concluding Remarks

Once again, IETA extends its appreciation to ARB Officers, Staff and the ARB Board Members for their continued leadership in developing a well functioning greenhouse gas market as a principal component of the cooperative effort to reduce greenhouse gas emissions in California across the WCI region. Through appropriate market design and execution – and transparent stakeholder communication on program design options, progress and results – IETA believes that ARB's offsets and cap and trade program will help to reinforce California's growing international reputation as a hub for global low-carbon investment and innovation opportunities.

On behalf of IETA and our member companies, I would like to thank you for providing this second opportunity to comment on the *California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms*, as well as for your attention to these comments. I respectfully request that ARB consider IETA's comments regarding overall concerns, and requests for clarification, associated with the draft roadmap.

We stand ready to answer any questions regarding our submission, and our members look forward to working with California officials to help inform their cap-and-trade design and implementation process. Please do not hesitate to contact Ethan Ravage (ravage@ieta.org), Anthony Mansell (mansell@ieta.org), or me if you have any questions.

Sincerely,



Henry Derwent
President and CEO