December 6, 2010

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

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

IETA is dedicated to the establishment of market-based trading systems for greenhouse gas emissions that are demonstrably fair, open, efficient, accountable, and consistent across national boundaries. IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our 165 member companies include some of North America's, and the world's, largest industrial and financial corporations—including global leaders in oil, electricity, cement, aluminum, chemicals, paper, and banking; as well as leading firms in the data verification and certification, brokering and trading, offset project development, legal, and consulting industries.

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

Although IETA strongly believes a national cap-and-trade is the best means of reducing greenhouse gas emissions in a cost effective manner, IETA commends ARB for their leadership in developing a framework that will both encourage and provide useful lessons in the development of a federal program. As you continue to revise the cap-and-trade draft regulations, IETA offers the following comments and recommendations:

Allocation and Auctioning of Allowances

ARB's 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. Given the scale of investment and financial capital needed for regulated entities to finance their allowance purchases at the start of a program, IETA is pleased to see a significant portion of emissions

allowances allocated to covered entities or covered sectors at the outset of the cap-and-trade program. Initial free allocation will reduce compliance costs and consumer energy prices and help California firms stay competitive.

However, IETA is concerned about the rapid decline in allocated allowances. ARB is planning on allocating the bulk of allowances to the utility and industrial sectors beginning in 2012. These sectors can anticipate a reduction in allocation of about 15% over the nine years of the program. Additional sectors that enter the cap-and-trade program in 2015 will see an even more accelerated decline. At these rates proposed by ARB, industry will find it very difficult to adjust to the increased costs of auction, threatening competitiveness, jobs and consumer energy prices. Significant time and capital investment are needed to meet long-term emissions reductions goals and transition California to a lower-carbon economy. IETA recommends phasing in the decline in allocated allowances over a longer period time, where initial auctions would be small and gradually increase at a steeper rate. This will help participants acclimate to the market and permit time for large capital investments to yield emissions reductions, keeping costs down and improving efficiency.

Non-Compliance Penalty

California's cap-and-trade program departs from the standard practice of imposing monetary penalties, as seen in the US Acid Rain program and the EU ETS, on each ton of excess emissions not covered by allowances in any compliance period. Instead, California's draft regulations have proposed a 4-allowance penalty per ton of emissions not covered: 1 allowance to be retired for each ton over and 3 to be placed in the Allowance Price Containment Reserve (APCR) account, available for auction if the reserve is activated and allowances available for purchase. IETA advises against using a non-compliance penalty based on the forced withdrawal of allowances, and instead recommends adopting a more traditional fixed monetary fine similar to those seen in the highly successful US SO_2 and NOx emissions markets.

A monetary penalty provides the following advantages:

1. **A monetary penalty provides price stability in an uncertain market.** As proposed, there is a gap of $30 between the initial reserve price at the allowance auction and first tier price in the APCR, meaning the allowance price has the potential to fluctuate substantially. For example, if the allowance price is low—at $10, or the reserve price—the penalty for non-compliance would be equivalent to $40 per ton. However, should the allowance price ever reach the first reserve tier price of $40, the non-compliance penalty would be equivalent to $160 per ton. Considering the EU uses a monetary penalty of 100 Euros ($135) per ton of excess emissions, the penalty fluctuations California could experience seem extreme. At the low end, the penalty may not be intimidating enough to encourage compliance, and at the far end, the penalty is far more severe than necessary. Establishing a predetermined monetary penalty ensures cost predictability, and if high enough, can dissuade non-compliance as the rational economic choice. In this regard, IETA recommends implementing a monetary penalty equal to the first reserve tier price in any given year, in addition to the forced retirement of 1 allowance for each uncovered ton.

2. **A monetary penalty does not force the market price to increase.** Under the current draft regulations, 3 allowances are to be placed in the APCR account, which would be

available for purchase should that account be activated. While this may not have a large effect on the total cap, it is likely to push prices up, as more allowances will only be available from the price containment reserve or at the ceiling price. This means all market participants, including entities that have met timely compliance, are all subject to the higher costs. In contrast, a monetary penalty has no affect on permit price or availability, sufficiently punishing non-compliers without subjecting all market participants to the after-effects of others' negligence.

Offset Market Development and Quantification Limits

IETA believes that an offsets can be effectively maximized through an appropriately designed framework. The framework should take the form of a bottom-up, criteria-based approach that allows offsets from any sector or project-type successfully meeting ARB's additionality criteria to provide incentives for as many high-quality low-cost emission reductions as possible. To this effect, IETA would like to offer the following recommendations:

1. **Increase usage limit based on quality, not arbitrary quantity limits:** ARB's cap-and-trade draft regulations would place an 8% cap on the percentage of offsets available to individual covered entities. While IETA is encouraged that ARB has significantly increased this limit from the original 4%, IETA continues to support the removal of a quantitative usage limit. IETA believes that as long as only real, permanent, and verifiable offset credits are allowed into the market, arbitrary usage limits will only prevent further reductions of greenhouse gas emissions in a cost-effective manner. Furthermore, program and entity usage limits would create uncertainty for offset project developers and investors with long-term planning horizons.

2. **Expand list of eligible domestic offset protocols:** ARB's cap-and-trade draft regulations list four Climate Action Reserve (CAR) protocols used to classify compliance-eligible offsets and those eligible to receive early action credit: livestock manure, urban forestry, U.S. forestry and U.S. ozone depleting substances. IETA is concerned limiting eligible offsets to these four project types alone would cause an immediate supply shortage. We feel there are simply not enough offsets presently available under these four protocols to provide the market with sufficient supply in the early years of the program 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:

   a) **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 Voluntary Carbon Standard and the Gold Standard. Recognizing existing projects will help to create a greater initial supply of offset credits for the market.

b) **The reorganization of offset credits from ARB-approved offset programs.** In addition to expanding CAR offset limits and criteria, state officials must 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. In addition, IETA strongly supports ARB's consideration of Reduced Emissions from Deforestation & Degradation (REDD) credits into its state program.

Utilizing the greatest possible geographic scope for issuance without compromising administrative efficiency or duplicating efforts already established or underway in other jurisdictions will help to ensure that demand is met while bringing quality offsets to the California market faster. Arbitrary geographic, activity-specific, or other limits do not promote environmental objectives, but simply encumber the ability of offsets to meet demand and provide cost containment while doing nothing to improve the ration of high-to-low quality credits overall. Robust standards for environmental equivalency should be the limiting factor, with no reference to quantity or location.

3. **Streamline accreditation for early action:** ARB's cap-and-trade draft regulations have taken proactive steps to recognize early action by establishing rigorous criteria for early action approval. While IETA is pleased to see ARB recognize early actors that have invested in low-carbon and clean technology projects, IETA has concerns the process for accreditation of early action credits and their potential transition to ARB-certified offsets is an administrative burden. In order to bring the greatest level of efficiency to this process, IETA recommends ARB not set a pre-requisite of re-verification of early action offsets and instead define a process in the early stages of the program to enable ARB-approved verifiers the ability to re-verify Climate Reserve Tonnes (CRTs). This will facilitate the process and reduce uncertainty on the transference of CRTs. Such a program will enhance liquidity early in the offsets market, which is essential to reduce compliance costs. This also will enable firms to hedge more confidently early in the program, further reducing the costs of the program.

4. **Expand the eligibility for early action offset credits to non-CAR domestic and international programs.** While IETA commends the hard work CAR has undertaken to develop a strong offset mechanism, we strongly believe that other offset programs, regulating domestic and international offsets, maintain equally high standards of environmental integrity. Restricting eligible early action offset credits to CAR seems arbitrary and may lead to the under supply of the market in crucial early years. IETA urges ARB to consider approving existing protocols/methodologies under other domestic and international offset programs like the Voluntary Carbon Standard and the Gold Standard for acceptance as early action offsets in the California cap-and-trade system.

5. **Replace ability to invalidate offset credits with requirement to acquire and cancel equivalent amount:** Sec 95985 of ARB's cap-and-trade draft regulations stipulates that offset credits can be invalidated after issuance due to a finding that a reversal occurred in a forest sequestration project, or if ARB determines 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. IETA understands and shares ARB's desire to maintain the

environmental integrity of the emissions cap, but believes that providing ARB the ability to invalidate issued offset credits is the wrong avenue to do so.

The Alberta offset system is a good example as it does not issue offset credits and has faced many problems as a result. Instead of issuing offset credits, the Alberta government audits offset projects after the offsets have been produced and submitted for compliance by regulated facilities. Depending on the results of the audit, the government may accept or revoke all or a portion of the offsets. As a result, the compliance entities in this program do not know until after they have submitted their compliance reports and offsets to surrender whether credits actually meet the grade. This creates an enormous amount of uncertainty and risk for compliance entities who invest in these projects, which is not conducive to the growth of a healthy and active offset regime. California's proposal to invalidate issued offsets is likely to lead to the same risk, threatening compliance, increasing administrative costs and decreasing offset supply. To resolve this, IETA proposes ARB requires the liable party acquire and submit for cancelation an equivalent amount of offset credits *or* allowances. This change will continue to ensure the integrity of the cap, while allowing a measure of flexibility to market participants.

6. **Place the liability for invalidated/erroneous offset credits on the project owner.** In a fully functioning carbon market, the end users of offset credits will have a similar connection to a surrendered offset as a person has to the dollar in their pocket before they hand it to the cashier. Most likely, they were not responsible for the project that led to its issuance, and they should not be held liable for either an intentional reversal related to that project or any errors made in the documentation of that project. Discouraging the purchase and holding of offsets, such responsibility lies with the project owner, and thus any related liability for the erroneous issuance of offset credits should logically be placed on the project owner as well.

7. **Limit the time period during which erroneous documentation can lead to the requirement to acquire and cancel an equivalent amount.** The draft regulations contain no statute of limitations limiting the time period during which erroneous documentation can lead to a offset invalidation. Maintaining the ability to reopen a case at any point in the future is completely out of touch with modern legal systems, where it is acknowledged that facts and evidence are obscured through the passage of time. Moreover, the omission of a time limit for invalidation means that the liable party will face unlimited and *increasing* levels of liability as long as they remain active in the cap-and-trade system. This makes the invalidation risk very difficult and increasingly expensive to manage, and will lead to long-term issues with market liquidity. IETA believes that the desire to maintain the integrity of the cap must be balanced with the desire to create and maintain a healthy market with manageable costs to participants. IETA suggests, therefore, that ARB include in their cap-and-trade regulations a strict 2-year statute of limitations on the ability to find documentation erroneous.

8. **Further clarify criteria for a finding of erroneous documentation.** The draft regulations stipulate that credits can be found erroneous in the event of errors in documentation "sufficient to warrant a reversal". IETA believes that this criteria [Sec. 95985 (b)(2)] should be further defined. The criteria for reversal should be in the event of intentional fraud or malfeasance on the part of a project owner, verifier, or end user. This reversal risk can then

be managed in contracting between the parties involved in the project activity. Errors without intent are infrequent and so minor in nature that they do not justify the potential restriction on liquidity that is likely to occur under the current proposed rules.

Sector-Based Offset Crediting Programs

1. **Expand Provisions for International Offsets.** The draft regulations state that sector-based crediting is a concept that has emerged in international climate forums as an opportunity to broaden the scope and scale of emissions reductions in developing countries. While this is true, attempting to transform that concept into tangible programs has proven incredibly challenging to date. Heterogeneity among installations in any given sector and the inability or unwillingness of governments to closely regulate or coordinate emissions reductions across a sector are just two among many challenges. While IETA believes that sector-based programs should continue to be explored and developed where possible, we believe that excluding project-based international offset credits from the California cap-and-trade system unnecessarily and quite severely restricts the sectors and countries that could supply offset credits into the California system. We recommend ARB expand the eligibility for international offsets beyond sector-based credits to also include project-based credits issued by external bodies using methodologies approved by ARB.

2. **Consult closely with public and private stakeholders when developing REDD program rules.** IETA commends ARB's choice to focus on the creation of an offset mechanism for compliance-based REDD offsets as the first sector based program to be incorporated into the cap-and-trade program. Deforestation is a unique problem that requires extensive public-private partnership. IETA also believes that the proposed goal of having REDD offset credits from pilot programs enter the California market at some point during the first compliance period is appropriate.

   Regarding the establishment of reference levels for REDD programs, IETA believes that the staff's initial thinking--that this reference level should be derived from absolute deforestation based on historic emissions averaged over a 10-year period and adjusted if necessary—is a good start, but believes that critical adjustments will need to be made to this historical baseline in many cases.

   Regarding the establishment of a crediting baseline, IETA is very concerned about the statement in the Staff Report that the REDD program must set a crediting baseline based on specific targets for 2020 and beyond. Given the tendency to confuse the concepts of baselines and targets/policy goals in recently proposed US legislation, IETA feels the need to emphasize that a baseline sets the incentive to reach a target; the two are not interchangeable. There have been several studies concerning the impact of baselines and reference levels on participation in REDD activities as well as many proposals put forward about the most appropriate way to establish reference levels and baselines.

   Finally, IETA welcomes the Staff Report's provision for nested crediting for REDD programs under the California cap-and-trade system. The ways in which projects are nested and the risks associated with under-performance shared among public and private actors, however, will need to be carefully thought through as the full REDD program rules are drafted.

Finding a way to fully integrate project-level activities within a state-wise system is essential to ensure the successful implementation and financing of REDD programs.

Given the complexity of these issues, and the fact that developing rules for a sector-based REDD program is truly uncharted territory, IETA believes strongly that ARB should consult closely with a wide variety of public and private stakeholders as it moves forward. IETA looks forward to providing further, extensive input to this discussion over the next year.

Holding Limits

ARB draft regulations establish a limit on the amount of compliance instruments that may be held by any single or affiliated group of entities. One can assume that ARB is considering these provisions as a means to prevent unacceptable market power by any single market participant. However, in our experience such holding limits are difficult to effectively enforce and can actually impede the proper functioning of a cap-and-trade program, particularly in the early years of the program. In order to deliver the full benefits of the market for consumers, these draft regulations need to encourage participation not just from covered entities but also from other liquidity providers so as not to discourage legitimate participation by non-emitting investors and entrepreneurs, which would create a risk of reduced liquidity.

Furthermore, by identifying carbon offsets as a primary tool for cost containment and placing limits on offsets usage, it is unlikely that a firm could gain such a commanding presence in the offsets market that it could manipulate prices. This is particularly true in a market that will trade predominantly in allowances. The overall market design has other built-in safeguards against manipulation by offsets sellers and covered entities have a wide range of compliance options. If an offsets seller attempts to manipulate prices, covered entities can utilize banking, internal abatement and potentially other recognized allowance markets. These flexibilities not only lower costs for covered entities, but they also protect against market abuse by offsets sellers. In addition, given the regulatory and technical risks in developing offsets projects, holdings limits would create an additional regulatory risk for offsets projects that could discourage supply formation. This would, in turn, work against the cost-containment goals of California's offsets policy. We note that the EU carbon market, as well as the US SO_2 and NOx markets have operated successfully for many years without holding limits.

Should ARB be concerned with market power, it may find existing regulatory programs for trading markets have already addressed this issue. For instance, Derivatives Clearing Organizations (DCOs), as designated by the U.S. Commodity Futures Trading Commission (CFTC), establish "position limits" on traders in specific commodity markets. Under the recently passed Dodd-Frank Act, which reforms derivatives market regulation, the CFTC will likely exercise the authority to set these limits. IETA recommends California rely on the relevant DCOs or the CFTC to set appropriate holdings limits, as both have the expertise and flexibility to adjust position limits as the liquidity of the market fluctuates.

Trading

ARB's trading provisions (Sections 95920 & 95921) stipulate that trading counterparties must be disclosed to ARB and all trades must be reported within 3 days of the transaction. IETA understands ARB's need for market transparency in order to enforce holding limits and ensure compliance. However, IETA is concerned that the reporting provisions within the proposed rules are too broad in nature, and ultimately may have the unintended consequence of restricting liquidity of trading markets. Our concerns are as follows:

1. **ARB's proposal is unworkable under anticipated market conditions**: The proposed draft regulations require the reporting of all "trades" of compliance instruments under the California program, but the proposal's ambiguity may present difficulty for ARB toward using this provision to adequately oversee the market. It is likely the trading of compliance instruments in California will involve a variety of structures from bi-lateral physical spot trades to over-the-counter trades for future delivery (forward trades) to exchange-traded contacts for future delivery (futures). Eventually derivative trades, such as swaps and options, will develop for the California market. With the exception of spot (or cash) trades of compliance instruments, all of these structures involve delivery (or potential delivery) at some point in the future. It is very likely market participants may trade in and out of these positions over the term of the contracts, and some may never take actual physical possession of the underlying compliance instrument.

   Proposed ARB requirements to report each trade will leave the Board with a large volume of trade data that will not properly represent holdings of compliance instruments, as positions will be modified considerably before actual delivery. Also, companies engaged in financial hedging activities or trading in California carbon compliance instruments for investment purposes may result transaction volume in excess of actual supply. This is a common attribute in many commodity trading markets, including the EU ETS, where trade volume in 2009 was 2.5 times the number permits allocated for that year.

   Under the proposed rules, ARB would be faced with a constantly shifting view of compliance instrument trading that is likely not representative of actual holdings. As such, IETA recommends ARB gather data only on trades as they go to physical delivery. In the case of spot transactions, this would be immediate. In the instance of OTC forward, futures, and options trades, this would be at the time of delivery under the terms of the contract.

2. **ARB should not require reporting of trade pricing.** ARB proposes to require market participants to report the price of trades, among other information. This requirement may restrict liquidity in the market, and perhaps run counter to federal derivatives trading draft regulations. In general, market participants consider the price of transactions to be highly confidential. In addition, reporting price information from individual trades is not feasible for regulated marketplaces, such as exchanges. These trading venues are prohibited from reporting this information per draft regulations established by the Commodities Futures Trading Commission.

   IETA also questions the need for ARB to gather price information from individual trades. This information is irrelevant to the enforcement of holding limits or to monitor companies for environmental compliance. Furthermore, price transparency for market participants,

which is an essential element to a properly functioning market and for the operation of proposed cost containment mechanisms, can be obtained from existing sources, such as news outlets, exchanges, and market intermediaries (i.e. brokers), without divulging the price of individual trades.

3. **There is no language on what ARB would do with data on forward/future trades**: The collection of trade data is sensitive, and IETA is concerned with the lack of clarity in the proposed rules on how the data would be used by ARB. If the full set of data becomes available to the public, IETA has concerns this could deter trading and put regulated entities at risk for market manipulation. IETA recommends that reported trade data not be made available to the public. Rather, ARB should consider making available to the public aggregate data on trading activity. In addition, the CFTC will have the authority to collect all of the carbon market transaction data for the purpose of regulating trading in these markets. ARB may want to consider establishing a formal information sharing relationship with the CFTC for the purposes of market oversight. IETA understands this recommendation to be the intent of ARB, and we encourage ARB to clarify this intent through modification to the final rule.

Linking

IETA is pleased to see ARB's cap-and-trade draft regulations consider the issue of linkage, not only with other WCI jurisdictions but with other regional and international schemes as well. Based on evidence and experience, linking regional and worldwide emissions trading markets would provide greater market liquidity while encouraging the realization of the most cost-effective reduction opportunities for greenhouse gas emissions. As previously mentioned, it is important that allowances purchased in trading markets from outside of California are accepted, provided these units emerge from jurisdictions that have comparable degrees of administrative and environmental integrity. We urge you to continue these discussions with increased urgency as it appears the establishment of a federal program is not immediately forthcoming.

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

Sincerely,

Henry Derwent
President and CEO