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

RE: Evolution Markets' Comments to the Air Resources Board on Proposed Regulations for California Cap on Greenhouse Gas Emissions and Market-based Compliance Mechanisms

December 14, 2010

Dear Sir/Madam:

Evolution Markets commends the California Air Resources Board ("ARB") on its continued progress toward the implementation of Assembly Bill 32 ("AB 32"), and we welcome the opportunity to provide comments on the design of the California Cap-and-Trade Program.

Evolution Markets is a leading financial services firm providing professional brokerage, structured transaction, and merchant banking services to participants in the global environmental markets. Our Carbon Markets Brokerage Group is among the industry's largest, and through our offices in San Francisco, New York, London, and Beijing, we have been active in facilitating many of the global carbon market's pioneering transactions.

Principals at Evolution Markets have participated in market design with various international, regional and state authorities as many of the global carbon markets underwent their formative stages. Evolution Markets' principals also have more than ten years experience facilitating emissions reduction credit (ERC) transactions in California's various air districts, as well as trades under the South Coast's RECLAIM program. As such, Evolution Markets has been a consistent advocate for market-based approaches to reducing emissions in California. Our belief is that cap-and-trade programs can be an effective tool for achieving environmental goals at the lowest possible cost.

While we believe California consumers can see similar cost-containment benefits from the carbon trading program outlined in the ARB's Proposed Final Regulation, the market must be designed in such a manner that empowers these ends. This is the focus of Evolution Markets' comments on the proposed regulations. Below we offer suggestions for market design that will lead to a transparent, efficient, and cost-effective program for the implementation of the ambitious greenhouse gas emission program under AB 32.

We appreciate your consideration of the following as you continue to promulgate the rules for such a program:



I. Offsets Program

A. Ensuring Adequate Offset Supply

Carbon offsets from non-capped sectors in California's cap and trade program will be an essential cost containment mechanism available to covered entities. They will provide lower-cost emission reductions, particularly early in the program when marginal abatement costs will be high. The quality and the integrity of the carbon offset are critical to safeguard in the design of the offsets program, and because of this, quality and integrity rather than project type, should be the primary concern of the ARB.

Evolution Markets defends and advocates for well functioning, liquid markets and believes that so long as the quality and integrity of the offset is safeguarded through the application of the stringent criteria the ARB has identified for offsets, all project types meeting the ARB's regulations and the ARB's criteria should be included in the program.

To ensure adequate offsets are available at the outset of the program, as well as sufficient market liquidity, Evolution Markets believes **the ARB should provide in January 2010 a Policy Statement stating the ARB's intent to allow any offset project type from an uncapped sector so long as it meets the ARB's stated offset requirements.**

B. Early Action Offset Supply

Evolution Markets believes that the proposed rules establish a robust system for early offset creation, but encourages ARB to consider changes in order to ensure an adequate supply of offsets during the initial years of the program. To this end, Evolution Markets recommends:

- 1.) **Establish Criteria for Additional Protocols Qualified for Early Action:** ARB has already taken the step of indentifying four protocols that may be used to generate offset credits for early action. In fact, ARB made this indication early in the rulemaking process, and thereby stimulated considerable investment in these project types. Evolution Markets recommends ARB consider establishing clear criteria for additional project types that may qualify for early action – criteria that is predicated on the inclusion of projects that can quickly generate large volumes of offset credits. Recommended criteria may include:
 - **High Quality:** Offset protocols must be of the highest quality. Therefore, they create offsets that are real, additional, quantifiable, permanent, verifiable and enforceable.
 - **Reputable Standards:** Offset protocols must be originated by standards agencies with consistent and long-term reputations for integrity. Furthermore, ARB should consider the adoption of protocols from standards agencies that already have a broad set of accredited and experienced verifiers.
 - **Abundant Issued Supply:** ARB should also choose the next round of standards qualifying for early action based on the availability of supply. Consideration should be made to protocols that meet the above criteria and have an existing abundant supply of issued offsets that can be immediately traded in the market.
- 2.) **Provide a Priority List of Projects Types that will be Considered for Early Action:** Furthermore, to ensure investor confidence and thereby to bolster adequate investment in offset projects

before the program begins, Evolution recommends ARB release a “priority list” of project types which the ARB has preliminary applied the criteria to and which the ARB intends to accept for compliance purposes.

Based on the criteria above, ARB should take every effort to identify protocols in addition to the four Climate Action Reserve (CAR) protocols already part of the proposed rules. By making this declaration, ARB will stimulate immediate investment in these project types, increasing the likelihood of availability of low-cost offset supply early in the program. As such, Evolution Markets recommends consideration of the following project types:

- Destruction of Landfill Gas Methane¹
- Destruction of Coal Mine Methane/Ventilated Air Methane
- Destruction of Ozone Depleting Substances from Countries Outside of the U.S.²
- Destruction of N₂O
- Agricultural Practices

- 3.) **Expanding Early Action Program to Include Additional Offsets Standards Agencies:** ARB’s entire list of initial qualifying protocols have been developed by CAR. Evolution Markets fully supports the inclusion of offset protocols from CAR, but we also encourage ARB to consider protocols from other well established offsets standards agencies. This would increase the capacity to generate acceptable protocols, and therefore offset supply.

In general, more strong signals are needed for the market to continue to invest in offset projects. At this stage, significant investment capital is not being deployed because of the continued uncertainty on project types in California’s cap-and-trade market, most notably in the coal mine methane sector. At this stage, the voluntary market alone is not enough to incentivize investment in highly uncertain project types such as coal mine methane. The sooner the ARB provides clear signals to market, the sooner capital investment will flow to the next set of project types, and the sooner California see early offsets supply.

C. Qualifying CRTs as ARB compliant

¹ Evolution Markets acknowledges California’s policy to regulate methane emissions from landfills starting January 1, 2011. Given this, all offsets from landfill gas are additional in the California case up until the date landfills become regulated. Outside of California, EPA regulations on landfills specify different thresholds requiring landfills to manage methane emissions. Because of this, some non-California landfills in many cases may be considered additional and have longer crediting periods. To date, the Climate Action Reserve has issued 3.9 million CRTs from landfill gas representing roughly 46% of the overall issued supply of CRTs (equaling 8.5 million). This supply will significantly assist California in achieving its policy objective of containing compliance costs early in the program. If accepted, this supply would also meet the stringent offset criteria set out by the ARB for offsets in a California cap-and-trade program.

² Specifically, Evolution Markets encourages ARB to consider inclusion of offsets generated from the destruction of ODS in Canada and Mexico. To that end, Evolution Markets believes that a footnote inserted into the Staff Report (Section III, page 11), which states that Mexico has not phased out ODS and therefore would not be eligible for offsets, is in error. Mexico is an Article 5 country under the Montreal Protocol. As such, Mexico is required to completely phase out production of ODS by January 01, 2010. Therefore, any project destroying ODS originated in Mexico after this time would be considered additional.



Evolution Markets commends the ARB for recognizing carbon reduction tons (CRTs) from certain CAR protocols as Early Action Credits and believes this approach will bolster early supply and liquidity in the market in 2011 and beyond. While it is a strong first step, Evolution Markets believes that **the ARB should define in Q1 2011 an administratively simple and non-onerous process for certification of Early Action Credits for compliance.** As the market evolves, project developers sell credits to manage risk and generate cash flow. These offsets in many cases have been bought and sold several times since the primary transaction. Therefore, for most projects that have produced eligible CRTs for Early Action Crediting, the CRTs are dispersed in throughout the market amongst many owners.

To address this issue, Evolution Markets recommends the following:

- 1.) **Establish Streamlined Accreditation Process for Verifiers:** The first step in ensuring the market's confidence in Early Action Credits is establishing an ARB accreditation program for verifiers. The sooner Early Action Credit owners can re-verify eligible CRTs to ARB-compliance grade, the sooner liquidity and trading will increase in California. Keeping in mind that credits from offset projects can be owned by several entities, the unifying element in an offset project is often the original project verifier. Therefore, Evolution Markets recommends **ARB accredit existing CAR-accredited verifiers for offsets in Q1 2011 so that CRTs can be re-verified to be fully compliance grade.** This will allow a seamless and efficient transition from Early Action to ARB certification.

Because the CRT registry allows CAR to identify every credit issued to every project, we recommend that ARB-accredited verifiers work directly with the CAR administrators and the project developer in re-verifying eligible CRTs as compliance grade. Early Action Credit owners will in many cases not have access to the requisite documentation to facilitate the re-verification event. In most cases, the project owner/developer is the most appropriate person to coordinate with to achieve re-verification. Since the verifier will already be working with the project developers on the current year verification, they can also provide any documentation for historical issued credits for the purposes of a one-time re-verification. The incremental cost associated with the re-verification of historical issued CRTs can be borne by the current CRT owners.

- 2.) **Establish a "Fast Track" Certification Program for Early Action Credits:** Evolution Markets also believes that establishing a clear and efficient certification process for Early Action projects as ARB offsets will incentivize compliance entities to begin using the pre-compliance offsets market to hedge, which in turn helps achieve the lowest cost of compliance. Evolution Markets recommends once ARB-accredited verifiers are available to the market, **ARB should allow for re-verification as part of future credit verification events for eligible CAR projects.** ARB should consider a special "fast track" procedure for this re-verification, basing documentation for this process on requirements of existing standards.
- 3.) **Establish Offset Registry as Soon as Possible:** Finally, in order to ensure that Early Action Credits can be issued, tracked, monitored and transferred amongst market participants, it is imperative to have a functioning registry for offsets. Evolution Markets believes **ARB should by Q2 2011 establish the legal agreements and necessary infrastructure support to enable an External Offset Registry, as defined by the Proposed Final Regulation.** This will ensure that market participants can continue to buy and sell credits thereby supporting market confidence and easing contracting for delivery of credits. This will



reduce potentially redundant transaction costs thereby reducing overall compliance costs, and will further support market liquidity.

D. Invalidation of Offset Credits

In *Section 95985* of the proposed rule, ARB proposes a mechanism for the invalidation of offset credits. While Evolution Markets understands ARB's desire to maintain the environmental integrity of the offset program and ensure the State meets its greenhouse gas emissions reduction targets, this provision could have an adverse impact on investment in offset projects and liquidity in trading markets for California compliance instruments.

The ability for ARB to invalidate offsets that have already been issued by ARB, and perhaps submitted for compliance, under what Evolution Markets considers to be unnecessarily broad conditions would introduce an unacceptable element of uncertainty to the offset market. The result could be a reluctance of market participants to invest in offset projects and a difficulty in creating necessary liquidity in secondary offset markets.

The best approach to ensuring the environmental integrity of the program is to put in place a robust system of protocols, validation, and verification, and thereby obviating the need for an invalidation process. Barring this, Evolution Markets recommends the following changes to the invalidation procedure:

- 1.) **Establish a Limitation on Invalidation:** As currently written, the proposed rule sets no limitation on when ARB may invalidate issued credits. This makes the invalidation risk difficult to manage for all counterparties. It can also constrict capital investment and secondary market liquidity over the long term. **Evolution Markets recommends establishing a time limit for the invalidation period, and we believe a two-year look back from the time of issuance is reasonable.**
- 2.) **Establish Proper Criteria for Invalidation:** *Sec. 95985 (b)(2)* of the proposed rules states that credits can be invalidated in the event of errors in documentation "sufficient to warrant a reversal". Evolution Markets believes this to be too broad. Experience in other offset markets shows errors in documentation to be infrequent and most often caught during the verification process. Any errors discovered after issuance, however, are most likely so minor in nature that they do not justify the potential restriction on liquidity that is likely to occur under the current proposed rules. **Evolution Markets recommends the criteria for reversal should only in the event of intentional fraud or malfeasance on the part of a project owner, verifier, or end user.**

II. Trading

Sections 95920 and 95921 of the proposed rules stipulate that trading counterparties must be disclosed to ARB, and all trades must be reported within three days of the transaction. Evolution Markets fully supports ARB's goal of market transparency, and its ability to monitor the trading market in order to enforce holding limits and ensure environmental compliance. However, Evolution Markets recommends ARB provide further detail in the regulatory language on what types of information will be reported and how the Board may use this information. Without such clarifications, the trade reporting rules may have the unintended consequence of restricting liquidity in trading markets.



Evolution Markets offers the following recommendations:

1. **More Clearly Define the Type of Transaction that is Reported:** The proposed regulations require the reporting of all trades of compliance instruments under the California program. The use of the term “trade” may present difficulty to ARB in the acquisition of useful transaction data. Evolution Markets anticipates trading in California compliance instruments to be highly liquid and take place in a variety of venues, using a variety of products. Many of these transactions, such as forward and futures trades and derivatives (i.e. swaps and options) involve physical delivery of compliance instruments at some point in the future – if at all.

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. **Evolution Markets recommends ARB gather data only on trades as they go to physical delivery and transfer within the ARB-established registry system.**

2. **Restrict Dissemination of Trade Data to the Public:** The data requested by ARB, either the broad trade data interpreted above or a more restrictive interpretation as transfer data only, would include elements considered proprietary by market participants. Specifically, counterparties rarely allow information on the timing, size or price of their trades to be made public based on competitive concerns, and the availability of such information can make market manipulation in some cases easier to achieve. Requirements to submit such data to the regulator, and the potential for this data to be made available to the public, may also inhibit market liquidity.

The proposed rule does not indicate what data, if any, will be made available to the public. **Evolution Markets recommends that reported trade data not be made available to the public. As necessary, ARB can market available to the public aggregate trade data.**

Again, Evolution Markets welcomes the opportunity to comment on ARB’s proposed rules for the implementation of AB 32. We appreciate your consideration of the comments above. If you wish to further discuss our recommendations, please feel free to contact John Battaglia in our San Francisco office at 415.963.9137 or myself at 914.323.0265.

Yours Sincerely,

Lenny Hochschild
Managing Director, Global Carbon Markets
Evolution Markets Inc.

