IETA

16 October 2014

Richard Corey
Chief Executive Officer, California Air Resources Board
1001 "I" Street, Sacramento, California 95814

IETA COMMENTS ON PRELIMINARY DETERMINATION

Air Resources Board Compliance Offset Investigation Destruction of ODS

On behalf of the International Emissions Trading Association (IETA)[1], we appreciate this opportunity to comment on the Preliminary Determination of California Air Resources Board (ARB)'s investigation of ARB Offset Credits (ARBOCs) issued for Ozone Depleting Substances (ODS) projects, which used Clean Harbors' incineration facility in Arkansas. According to the report, ARB's Executive Officer has made a preliminary determination that **231,154** offsets – from two separate projects over two reporting period at Clean Harbors – are now subject to invalidation.

IETA continues to support regulators' efforts to ensure that offsets used for compliance in California's program meet ARB's rigorous environmental standards and relevant statutory/regulatory requirements. This message was featured prominently in IETA's June comments to ARB, submitted during Clean Harbors' initial 25-day comment period, along with other substantive issues and program improvement recommendations to prevent similar situations from playing-out in the future. Beyond this submission, IETA delivered a letter to ARB in August, highlighting potential market implications and concerns related to the Clean Harbors' investigation process and timeline.

After months of uncertainty and awaiting status updates, IETA welcomes clarity on the investigation. However, based on reasons highlighted below, we believe that moving to invalidate the affected credits, as proposed in the Preliminary Determination, is not justified and sets a precedent with repercussions on California's offset market development.

In response to ARB's **Clean Harbors' Preliminary Determination**, IETA's comments are structured around the following areas:

1. **Alleged Violation vs. Actual Violation;**
2. **ARB's Requirement to Exercise Discretion in Considering Invalidation;**
3. **Regulatory Compliance Language;**
4. **Investigation Process & Timing;**
5. **Precedent-Setting Dangers;**
6. **ARB Regulatory Non-Conformance Concerns;**
7. **Market Impacts & Invalidation Risks; and**
8. **Final Considerations on "Buyer Liability".**

[1] *IETA is an international business association representing over 140 leading international companies from across the carbon value chain. IETA has extensive experience with greenhouse gas market-based trading programs worldwide, including compliance allowance and offset programs. www.ieta.org*

IETA

1. Alleged Violation vs. Real Violation

Section 95985(c)(2) of California's cap-and-trade regulation gives ARB the authority to investigate and invalidate issued compliance offsets if: "*the offset project activity and implementation of the offset project was not in accordance with all local, state, or national environmental and health and safety regulations during the Reporting Period for which the ARB offset credit was issued.*"[2]

IETA understands that ARB's investigation was triggered by the US EPA's April 2014 Compliance Agreement and Final Order (CAFO)[3] regarding Clean Harbors' compliance with the Resource Conservation & Recovery Act (RCRA). This happened as a result of two particular Clean Harbors' operations: the brine recycling operation, and the carbon canister monitoring operation. As noted in IETA's June comments, we contend that neither of these operations are directly applicable to ODS offset project activities, and the ODS project activities themselves were not subject to any enforcement actions.

More importantly, the settlement between the US EPA and Clean Harbors does **not represent an admission of guilt or violation** on the part of Clean Harbors. The CAFO clearly states that Clean Harbors "neither admits nor denies the specific factual allegations."[4]

It is unclear how ARB is in a position to use the CAFO, or related inspection reports, as a basis to invalidate affected offsets, given that: 1) concerns raised in the inspection reports do not constitute a formal enforcement action by the EPA, nor do they represent a formal notice of violation; 2) the CAFO is a settlement document, which cannot be used as a basis to prove liability under Federal and California law or under California Administrative procedures; and 3) California has not been delegated authority to administer or enforce the federal RCRA program by the EPA. Determining that the Clean Harbors facility in El Dorado was in violation of RCRA regulations, independent of a formal enforcement finding by the EPA, is beyond the jurisdiction of California.

Notwithstanding questions about whether or not a "violation" actually existed, it appears that any violation was "technical" rather than substantive. That is, selling brine was explicitly permitted prior to the sale of the truckload in question and appears likely to be resumed upon completion of "discussion" with EPA regarding the proper permitting. Therefore, it seems clear that neither intentional nor careless harm to the environment has occurred. Given that there are no questions about the environmental integrity of the affected offsets with regard to greenhouse gas emissions, and that no environmental (or any other) harm has occurred, it does not appear that invalidating the offsets in question serves any public policy purpose, and yet such invalidation runs the very real risk of damaging the long-term credibility of California's offsets program and potentially the overall cap-and-trade program among businesses, market participants, and investors in greenhouse gas reduction projects and technologies.

[2] *Article 5: California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms*
[3] *US EPA Consent Agreement and Final Order in the Matter of Clean Harbors El Dorado LLC (April 2014)*
[4] *ibid*

2. ARB's Requirement to Exercise Discretion in Considering Invalidation

According to the Cap-and-Trade Regulation, invalidation of offsets is discretionary, not mandatory. The following sections in the Regulation provide a strong presumption that, once an offset is issued, it will remain valid,[5] and expressly provide the ARB and the Executive Officer with broad ***discretion*** whether to invalidate such offsets:

> *Section 95985(c) ("ARB **may** determine that an ARB offset credit is invalid …");*
> *Section 95985(f)(4) ("The Executive Officer will have 30 calendar days after all information is submitted under this section to make a final determination that one or more conditions listed pursuant to section 95985(c) has occurred and **whether to invalidate ARB offset credits").***

IETA fully understands and supports ARB's need to ensure the integrity of offset creation. However, the Regulation makes it clear that a nominal violation does not require invalidation as a matter of strict liability, and instead enables the ARB to use discretion.

In this case, IETA submits that invalidation of offsets, given the limited and technical nature of the alleged violation, is not appropriate, and does significantly more harm than good. At the very least, the final decision should expressly indicate the factors considered in determining whether to exercise discretion to invalidate offsets in this circumstance, in order to provide market participants a clear understanding of both the regulator's thinking in this situation, as well as to place this particular situation in the context of overall market confidence in the still-unproven compliance offset program. **In future proceedings, such explanation should be made part of any initial finding, in order to allow parties an opportunity to comment.**

3. Regulatory Compliance Language

Clean Harbors' alleged non-conformances are not related to the offset project activity. California's existing regulation and currently adopted ODS destruction compliance protocol do not support invalidation of any ARBOCs related to alleged violations at the Clean Harbors' site. This includes the relatively small – but material – number of ARBOCs subject to invalidation during the final determination period.

ARB's recent amendments to Section 95973(b) of California's **Cap-and-Trade Regulation** helped to emphasize the importance of a direct relationship between non-compliance and the offset project itself. According to this section:

> *"…an offset project must also fulfill all local, regional, and national environmental and health and safety laws and regulations that apply based on the offset project location and that directly apply to the offset project, including as specified in a Compliance Offset Protocol. The project is out of regulatory compliance if the project activities were subject to enforcement action by a regulatory oversight body during the Reporting Period. An offset project is not eligible to receive ARB or registry offset credits for GHG reductions or GHG removal enhancements for the entire Reporting Period if the offset project is not*

[5] *See §95985(a): "An ARB offset credit issued under this article will remain valid unless invalidated pursuant to this section."*

in compliance with regulatory requirements directly applicable to the offset project during the Reporting Period"[6]

With the adoption of this amended provision, which came into effect on 1 July 2014, ARB took an important step towards more clearly defining that offset project activities must comply with environmental, health, and safety requirements that are *directly applicable* to the offset project and that any non-compliance event must result from an enforcement action levied against the project activities. [7]

However, there is a clear disconnect between the approved language in the adopted cap-and-trade regulation and the ***current*** ODS protocol regulatory compliance language. IETA sees a troubling precedent-setting activity, in which ARB appears to be pointing to the ***proposed*** *15-day draft language*, rather than adopted, regulatory compliance language in the given protocol. In its preliminary determination, ARB clearly points to ***proposed*** regulatory compliance language in subchapter 3.8 of the ODS Protocol, which reads as follows (where proposed 15-day amendments are single underlined).

3.8 (a) An offset project must meet the regulatory compliance requirements set forth in section 95973(b) of the Regulation.
3.8 (b) The regulatory compliance requirements for a project apply to the collection, recovery, storage, transportation, mixing, and destruction of ODS, including disposal of the associated post-destruction waste products. The regulatory compliance requirements extend to the destruction facility during the time ODS destruction occurs."

While IETA welcomes additional regulatory clarity, we are **concerned about the discretion that ARB took in interpreting (and subsequently clarifying) its regulatory language**. When a key regulator interprets and amends regulatory language post facto to validate its findings, it undermines the regulatory certainty that is needed for an efficient market to function. This is not simply a concern and risk for project developers, but for stakeholders involved across California's carbon market chain – including verifiers, investors, intermediaries, buyers and compliance entities. In IETA members' experiences, it is precisely this kind of shifting regulatory interpretations and uncertainty that is most difficult for investors and market participants to understand and manage.

4. Investigation Process & Timing

ARB's investigation has taken far longer and lacks the transparency that many stakeholders first expected, following ARB's initial announcement on 29 May 2014.[8] According to ARB's initial review notice, it appeared that staff planned to deliver a final determination within 30 days after its initial 25-day information gathering phase, which ended on 23 June. However, ARB later signalled their

---

[6] *ARB (August 2014) Final Amended Cap-and-Trade Regulations, Section 95973(b), Pages 260-261*
[7] *This stance was further supported by ARB in its May 2014 "Final Statement of Reasons" (FSOR) accompanying the regulatory revision, in which the FSOR states that "regulatory conformance is intended to be limited to (offset) project activities". See May 2014 Amendments to the Cap-and-Trade Regulations, Final Statement of Reasons, Response to Comment F-1.9, page 867*
[8] *At the time of IETA's initial June submission to ARB, affected stakeholders believed - based on official staff communication as well as initial conversations with staff - that the investigation would be transparent and a final determination would be swiftly delivered by late-July.*

official interpretation of the rules: the 30-day determination period is not stipulated to follow the 25-day information-gathering period, but can instead be launched based on staff's discretion. Until the release of its preliminary determination on 8 October, ARB did not signal when they intended to launch their 30-day final determination period for the review, which further added to the uncertainty and potentially affected market participants' ability to operate under clear and consistent timelines.

IETA is concerned about the precedent being set with the Clean Harbors' review, and how the ad-hoc approach to the review process will be undertaken by ARB in the future. ARB's discretion in interpreting regulatory language regarding the sequence and timing of its investigation further undermines the certainty needed for markets to function effectively, and could potentially damage the ability of California's program to meet its goals cost-effectively.

We respect and appreciate the role of agency interpretation in implementing regulations that often lack full clarity. However, having now been confronted with ambiguity in the regulatory text, **we believe it is critical for the ongoing development of AB32 to devise a set of steps, with clear and consistent timelines, that will govern ARB's invalidation process in the future.**

5. ARB Regulatory Non-Conformance Concerns

According to Sections 95985(d) and 95985(g) of California's Cap-and-Trade Regulation, ARB is required to suspend transfers of affected credits during an invalidation review process, but regulators are not permitted to remove offset credits from CITSS accounts until a final determination has been made. However, in the case of the Clean Harbors review, **ARB did not act in accordance with 95985(g), resulting in the premature and improper removal of offsets from individual CITSS accounts prior to a final determination by ARB.**

There are real and significant market, corporate and economic impacts around ARB's early confiscation of affected credits. For instance, some members noted that the automatic removal of credits from CITSS accounts caused considerable issues in accounting for the now-missing value of these credits over two critical quarter-end periods (June 30 and September 30) as well as establishing to auditors that title to those financial assets still remains clear and unencumbered with the account holders. This is in addition to the lost ability to transact and settle previously agreed transactions, as discussed below.

These impacts were only exacerbated by ARB's longer-than-expected review process and unknown determination timeline. **ARB needs to clarify its process for the future, and deliver better stakeholder communications regarding timing and rationale for these types of reviews.**

6. Market Impacts & Invalidation Risks

ARB's Clean Harbors review triggered the premature suspension of approximately 4.4 million ARBOCs on CITSS; an amount equivalent to nearly 50% of California's nascent offsets market. This type of action involving such a significant amount of issued ARBOCs (in this case, coming from what the market had considered the least susceptible project type to invalidation risk), may have major impacts on market participation and confidence.

Following the review's launch, some California project developers and multiple technology partners who had invested in ARB's offset program chose to freeze operations and halt growth. Small and large businesses that have been developed or expanded in the United States, including California, to support the AB32 program have been irreversibly damaged. In some cases, these businesses are no longer willing or able to continue their operations or participation in the market.

Many **offset project developers** are thinly capitalized entities that rely on revenue financing to sustain and grow operations and **technology partners** who require secure financial commitments. Since the launch of Clean Harbors' review, many developers have placed all credit issuance and new project development on hold and have been unable to sell their products. As a result, cashflow is frozen, placing many developers and technology partners in unsustainable financial positions. **Other market participants** have had to invoke *force majeure* clauses in contracts to manage the impossibility of honoring delivery obligations. And for **current holders** of credits from the two reporting periods subject to invalidation, this potential outcome will result in nearly $2 million in damages or write-downs based on no fault of their own and no conceivable ability to have performed appropriate due diligence to insulate themselves from ARB's discretionary invalidation of offsets.

Further, the investigation and preliminary determination may have longer-term impacts on corporate and project risk profiles, Golden CCOs[9], and the shape of emerging offset insurance products. As currently stipulated, **offset insurance providers** are in a particularly difficult position to evaluate the risks of invalidation during underwriting. ARB's narrow interpretation of facts during the invalidation investigation may likely discourage the insurance industry from issuing future insurance products, which allow potential buyers to manage offset invalidation risk, precisely because the conditions for potential invalidations and the procedures for investigating possible invalidations appears to be based on an arbitrary assessment and not conducted in accordance with the adopted regulations or based on the actual environmental integrity of the emissions reductions in question. Without these financial products available in the market to eliminate invalidation risk, potential buyers may be precluded from participating in the market that would otherwise provide an enticing cost-effective compliance option.

7. Final Considerations on "Buyer Liability"

Since invalidation provisions were first proposed by ARB, California market participants, market design experts and potential linkage partners have voiced concern about the potential risks and implications.

In light of the Clean Harbors' investigation and preliminary determination, **IETA suggests that ARB take this opportunity to revisit the appropriateness of invalidation provisions, particularly related to regulatory compliance, and consider alternate approaches to "buyer liability"**, such as the approach taken by Quebec.

Should ARB remain committed to using "buyer liability," notwithstanding that it depresses market activity, it is critical that regulators: 1) be as clear and consistent as possible in communicating the circumstances under which invalidations can occur; and 2) avoid invalidating credits for violations (or alleged violations) that credit holders, verifiers, and Offset Project Registries had **no**

[9] *Market terminology for ARBOCs with no invalidation risk; sold with guarantee to be replaced if invalidated.*

reasonable capacity to discover through due diligence. Failure to do so could discourage market participants to the point of making offsets functionally irrelevant to California's cap-and-trade system.

In Conclusion

IETA strongly supports ARB's efforts to not only ensure the integrity of California's market, but also to consistently recognize the critical cost-containment and co-benefit roles that offsets play in the system. We also recognize ARB's interest in expanding the number of eligible offset project types and establishing linkages with other jurisdictions. However, based on ARB's preliminary Clean Harbors' determination and investigation process to date, there could be far-reaching consequences to California's program – a reality that could effectively negate fundamental efforts to nurture a fully-functional, robust, and liquid California market.

We appreciate your time and attention to these comments. Please do not hesitate to contact Katie Sullivan (sullivan@ieta.org), IETA's North America Director, if you have any questions or follow-up requests related to the contents and recommendations in this letter.

Sincerely,

Dirk Forrister
IETA President and CEO

ABOUT IETA

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 140 member companies include some of California'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. More information about IETA, including its current regional and global membership and partner network, is available at www.ieta.org.