

CARBON MARKET

COMPLIANCE ASSOCIATION

September 15, 2016

Via Electronic Submittal

Richard W. Corey
California Air Resources Board
Transportation and Toxic Division
1001 I Street
Sacramento, CA 95814

Re: **NOTICE OF PUBLIC HEARING TO CONSIDER AMENDMENTS TO
THE CALIFORNIA CAP ON GREENHOUSE GAS EMISSIONS AND
MARKET-BASED COMPLIANCE MECHANISMS REGULATION**

Dear Mr. Corey:

The Carbon Market Compliance Association (“CMCA”) is a non-profit organization consisting of compliance entities and market participants. CMCA members are involved in California’s Cap and Trade program, including involvement in the Cap and Trade Auctions run by the California Air Resources Board (“CARB”), and secondary market transactions to manage price risk. Founded in 2014, CMCA provides an organized platform for carbon market compliance entities and other market participants to come together, discuss current issues affecting markets and compliance programs, and seek to promote the economic efficiency and fairness intended by such programs.

CMCA appreciates the opportunity to provide comments to CARB regarding the draft proposed amendments to the California Greenhouse Gas Emissions and Market-Based Compliance Mechanisms posted by CARB on August 2, 2016.

CMCA’s major concern with the proposed regulatory changes is maintaining the balance between: 1) solving the current supply and demand imbalances that have resulted in auctions with low subscription rates and large numbers of allowances being put into the Auction Holding Account (“AHA”), and 2) avoiding setting up the market for a possible

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shortage in the longer term. CARB's proposed regulations aim to solve the short-term oversupply by transferring unsold allowances to the Allowance Price Containment Reserve ("APCR") as referenced in section 95911, subsection (g) of the proposed regulations. While CMCA agrees with CARB that the surplus unsold allowances should be removed from the AHA and put into the APCR, CMCA is worried that when combined with other proposed regulatory changes and developments in the legal/legislative arena, CARB risks significant price volatility and potential price spikes in the future.

CMCA would note that the current lack of demand in the auctions, is the result of oversupply, which may reach as high as 300 Million tons by CMCA's estimates and also is from the significant uncertainty in the future of the cap and trade program. This uncertainty results from the Cal Chamber lawsuit and the lack of an explicit reauthorization of cap and trade by a two thirds majority vote of the California legislature. It is quite conceivable that this uncertainty could remain an issue through 2018 further dampening demand.

CMCA is concerned that once such uncertainty is resolved, pent up demand could be pulled forward as market participants suddenly start to hedge post 2020 obligations. At the same time proposed regulations have the potential to reduce future supply, increase future demand, and increases the risk that allowance auction prices will jump from the auction reserve prices to the APCR reserve price of approximately \$60 in 2020, a 4-fold increase. In order to protect against this type of destructive and politically untenable upwards price volatility, CMCA makes the following recommendations to CARB:

- 1) Not eliminating the price tiers as is currently being proposed by CARB.

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- a) Once demand outstrips allowances supplied through the auction and secondary market, the currently proposed one price tier at a \$60 price adder to the Auction Reserve Price for reserve allowances risks causing prices to quickly jump to \$75+ per allowance. Such a dramatic and possibly quick price spike risks destabilizing the market and the public's trust in the viability of the cap and trade program because the impact of such high prices on the economy and consumer prices could be damaging and reminiscent of the California Power Crisis in 1999-2000.
 - b) CMCA has completed an analysis that shows that as much as 200 million tons of unsold allowances could eventually be transferred from the AHA to the APCR by 2020. Combined with the volumes already budgeted for the APCR, the enlarged APCR coupled with multiple price tiers, could provide a valuable mechanism to slow or moderate upwards price volatility and, in essence, provide a series of "speed bumps" to market prices.
- 2) CMCA supports two-way linkages that provide a market structure where the reciprocal nature of complimentary programs increases depth and liquidity to the market. However, one-way linkages are problematic by design as they tighten the supply/demand balance without any accompanying benefit from a larger more liquid market. CMCA recommends CARB not allow one-way linkages in the regulation without further public consultation.
 - 3) CMCA supports the use of increased sector-based offset credits, such as REDD, but not at the expense of the current offsets market. CMCA therefore proposes that CARB work collaboratively with the legislature and other stakeholders to solicit their support prior to proposing regulations that may solicit a negative legislative reaction towards the current offsets market.

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In addition to the primary market structure concerns discussed above, CMCA also proposes several minor administrative adjustments to the regulations that would enhance market efficiency, and reduce compliance costs for market participants:

- 1) ARB should increase Holding Limits for CITSS account holders by 200% and standardize purchase limits for all market participants at 25%.
 - a) CARB's definition of a "Compliance" entity vs. a "Speculative" entity is arbitrary and does not accurately identify speculative vs. compliance purchases or market holdings and provides no useful information or protections to the market. CMCA uses the following examples to illustrate these arguments.
 - i) Entity A is a financial institution such a bank that typically provides financing services to the market. This bank only purchases Allowances from market participants in order to sell back to them the same volumes at a later date, effectively allowing participants to finance inventory of allowances at a cheaper rate than their internal cost of capital. The bank may also purchase allowances at auction in order to sell allowances to entities that can not participate in the auctions in a cost competitive manner. This bank is acting as a financial intermediary to the market and provides a valuable service without taking any material "Speculative" positions. Under current CARB rules this entity would be classified as a "Speculative" entity even though none of its' activities are "Speculative" in nature and its ability to provide these financial intermediation services is limited by CARB rules possibly harming market liquidity or costs for "Compliance" entities that would otherwise be able to use this bank's services.
 - ii) Entity B is a large firm specializing in financial "Speculation" but this firm imports into California 1 MWh per quarter to qualify as a "Compliance" entity.

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- It's "Compliance" obligations are less than 2 tons per year, yet it is classified as a "Compliance" entity under CARB rules and has all the same purchase and holding limits as the largest "Compliance" entities in the market. Entity B purchases and activities are classified as "Compliance" in market reports and disclosures but it is clearly a "Speculator".
- b) CMCA recommends that CARB standardize rules for all market participants and allow for larger holding limits to accommodate the proper functioning of the market and not unduly limit liquidity. If CARB has concerns about Speculative abuses, CARB should ask for more disclosure on holdings and purchases from market participants on a confidential basis, as it already has the right to do under the Regulations. This would allow CARB to monitor the market for potential Market Power abuses without affecting market liquidity, financing costs or financial intermediation.
 - c) CMCA would like to emphasize that it sees an important role in the market for "Speculative" market participants. Speculative participants provide valuable liquidity and actually reduce volatility by warehousing risk that "Compliance" entities cannot or are not willing to warehouse. Speculative participants buy when the market is viewed by these entities to be oversold and sell when the market is viewed to be overbought.
 - i) As the market expands with the addition of markets like Ontario in the future, the current regulations need to be modified in order to not limit market liquidity by arbitrary, and in many cases inaccurate, classifications by CARB regulations.
- 2) ARB should reduce the bid deposit requirements for participation in the quarterly auctions, allowing for offset from entities already holding allowances in CITSS or from compliance entities consigning allowances into the same auction. Bid deposit

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requirements when no credit RISK to CARB exists, increase transactional costs to market participants for no reason.

- a) Entities holding allowances in CITSS should be able to use those as collateral to offset bid deposit requirements. This would allow the market to operate more efficiently by reducing transactional costs for participating in auctions, particularly for smaller entities for whom the cost of posting such bid deposits or surety bonds can be excessive.
 - b) Similarly, compliance entities consigning allowances into the same auction should be able to use those as collateral to offset bid deposit requirements. If their consignments are larger than or equal to their purchases, why is there any credit risk to CARB or a need for a bid deposit.
 - c) CMCA supports the concept of bid deposits where credit risk to CARB exists but not when there is zero risk as detailed in the cases above. If CITSS rules need to be modified to allow CARB to use market participants' holdings as collateral, CMCA supports this change and requests such to facilitate this recommendation.
 - d) Since the cap and trade market was launched, we have been in a historically low interest rate environment where the cost of capital has been quite reasonable. As the Fed is now openly looking to move interest rates up, the cost of providing bid deposits will also increase to multiples of current levels and so the time for CARB to reconsider these regulations in order to keep costs reasonable and low for market entities is now.
- 3) CARB should conduct Current Vintage Auctions and Forward Vintage Auctions on separate days/times, to allow for participants to receive notification of purchases in the Current Auction prior to submitting bids in the Forward Auction.
- a) CARB should recognize that the outcome of the current vintage auction and individual participants' success or failure in such auction clearly affect the decision by market participants to bid in the Forward Auction. By holding both

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- auctions simultaneously CARB is potentially negatively affecting bids in both the Current and Future vintage auctions.
- b) CARB could easily separate the auctions with little or no incremental costs by holding the Forward vintage auction the day after the results of the Current vintage auction are announced.
- 4) ARB should increase flexibility to consignment sellers so they can respond to market signals and do not have to make as many “once-for-all” and one-time decisions about market participation.¹
- a) This would contribute to the smooth functioning of the market by allowing sellers to respond to market price signals, changes in their portfolios and auction results. This would be particularly useful for volatile years such as this one where very few predicted the crash in prices and auction volumes last year when consignment decisions were required.
 - b) Consignment decision elections 60 days prior to each auction or at the very least twice a year in October and April would balance the slight increase in administrative burden with additional flexibility for consignment entities.
- 5) CARB should amend the annual auction reserve price calculation from the current 5% + CPI to the greater of 5%+ CPI or 7% such that the annual increase is never less than 7%.
- a) In a negative (or low) inflationary environment, the current regulations suggest that the annual price adjustment could be lower than 5%. This was not the expectation of the government or regulators when the floor was adopted and has resulted in lower carbon prices and revenues than were expected.

¹ For example, in October each year, each POU must decide once and irreversibly how many allowances will be offered at market in the following year, and the commitment of volumes for each auction must be made months in advance as well.

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- b) A higher escalator would ensure that even in a low or negative inflation environment the reserve price would increase at a more predictable rate and that entities would be encouraged to act now to hedge risk or constrain emissions due to a higher expected cost in the future.
- c) Additionally, a higher and more stable escalation rate would more closely approximate entities cost of capital and incentivize long term investment in offsets and other emission reduction technologies.

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CMCA appreciates the opportunity given to it to submit these comments, plans to present these comments in person at the September 22, 2016 hearing and is happy to entertain any questions from CARB or other parties on these points at anytime.

The decision of CARB on these regulatory amendments will directly affect the members of CMCA who have invested substantial amounts of capital in a long-term and market-based solution to climate challenges in California and across the world, and as such CMCA asks that CARB carefully consider and evaluate the comments made in this letter.

Dated: September 15, 2016

Andre Templeman

Executive Director, Carbon Market Compliance Association (“CMCA”)

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Chair California Air Resource Board

Governor Edmund G. Brown, Jr.

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