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California Air Resources Board

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IETA COMMENTS TO CALIFORNIA AIR RESOURCES BOARD (CARB) POTENTIAL REVISIONS TO CALIFORNIA CAP AND TRADE REGULATION POST-2020

The International Emissions Trading Association (IETA) appreciates this opportunity to provide comments on California Air Resources Board (CARB)'s public workshop presentation, held on 26 April 2018, regarding possible revisions to California's cap and trade regulation ("**Presentation**") and the document entitled "Supporting Material for Assessment of Post-2020 Caps" ("**Supporting Document**").

We take this opportunity to stress that California's existing cap and trade program is working and should continue to be the instrument of choice for California policy-makers in reducing greenhouse gas (GHG) emissions both to and past 2020. An active and transparent cap and trade program, which empowers and drives market efficiencies, is essential in mobilizing private investment while unlocking the most cost-effective solutions across the multi-jurisdictional program.

As 2018 rule-making activities proceed, IETA hopes to see CARB focus significant efforts on strengthening the cap and trade program, operationalizing design improvements, and enabling future cross-border linkages to increase market participation, support cost-containment, and drive deeper emissions reductions across the economy.

In response to the post-workshop input, we encourage CARB to take into account several key considerations while moving forward with potential cap and trade amendments.

IETA's detailed comments and recommendations are structured around the following areas:

1. Maximizing Offset Usage
 - a. Direct Environmental Benefits
 - b. Additional Offset Protocols
 - c. Invalidation Procedures;
2. Unused Allowances and Post-2020 Caps;
3. Design of Cost-Containment Measures;
4. Ensuring Environmental Integrity;
5. Industrial Assistance Factors; and
6. Energy Imbalance Market.

1. MAXIMIZING OFFSET USAGE

DIRECT ENVIRONMENTAL BENEFITS

Assembly Bill (AB) 398 does not restrict one-half of offset usage to projects within California. Instead, the bill mandates that no less than one-half of the offset usage limit may be met with offsets that have in-state direct environmental benefits (“DEBS”). Had the legislature been more restrictive, AB 398 might have brought lawsuits based on the Commerce Clause; a scenario that would have spurred adverse market activity and confidence, while draining Agency resources.

Evidence from climate science shows that the atmosphere is a global sink. GHG emissions – and therefore GHG reductions and avoidances – anywhere in the world have direct impacts on California. While IETA continues to maintain that isolating California’s program with the DEBS provision is counterproductive to broad climate action, **we support CARB’s initial framework (see Slide 17 of Feb 2018 Discussion Draft).**¹

To simplify compliance and reduce administrative burden, IETA recommends that offset projects, physically located within the state of California, automatically earn designation as DEBS projects both for past and future ARBOC issuances. These credits should be grandfathered-in as DEBS without any additional administrative work on CARB’s behalf (e.g., retroactive tagging).

IETA also recommends that projects, not geographically located within California but that provide clear reductions/avoidances of any pollutant with adverse impacts on California air or waters, not be arbitrarily labeled as failing to provide DEBS. For instance, offset projects in neighboring states may benefit California air quality and many of these activities do – or could – benefit California waters. IETA welcomes the opportunity to share further evidence and case studies how current and/or future neighboring state offset projects drive in-state climate and co-benefits.

We question the framework for assessing a DEBS determination, as proposed by Near Zero. We believe this framework does not apply in the current context. AB 398 neither indicates a distaste for a gross accounting framework nor a preference for a net accounting framework for reductions or avoidances.

IETA underscores that offsets provide numerous benefits and co-benefits to California and beyond. For sectors with more dispersed emissions that are not covered by the cap, offsets provide an incentive to invest in climate projects. For Californian business and consumers, offsets provide lower-cost alternatives to meet the state’s reduction goals. This cost perspective will be especially important in the future, when allowance prices climb higher. Finally, offsets provide a tangible way for people around the country – from the White Mountain Apache Tribe in Arizona to Wisconsin dairy farmers – to engage with California on climate action while seeing for themselves that we can grow the economy in a climate-friendly manner.

¹ See the discussion draft here: https://www.arb.ca.gov/cc/capandtrade/meetings/20180302/ct_pdd_02232018.pdf.

OFFSET PROTOCOLS & UPDATING

Today, CARB has six approved compliance offset protocols, with the last one (Rice Cultivation) approved in 2015. In some cases, technical updates are needed to ensure accuracy. The ODS Protocol is an example where regulatory baselines, technologies, and underlying science has changed since that protocol was originated over a decade ago. In addition, there are several new protocols established under voluntary offset programs in conformance with rigorous technical standards that would meet CARB's rigorous review process. **IETA believes that this process to review and adopt new compliance protocols should begin as soon as possible.**

While the Compliance Offsets Protocol Task Force has not yet been convened, we also urge CARB Staff to review updated existing protocols and new protocols already published by voluntary offsets programs, as were many of CARB's existing compliance protocols initially.

INVALIDATION PROVISIONS

IETA encourages CARB to consider additional amendments to offsets provisions within this or subsequent proceedings. Amended regulations should: narrow the scope of grounds for invalidation; and shorten the invalidation period, so all ARBOCs are CCO3s without a second verification. Invalidation unnecessarily discourages use of offsets, thereby leading to higher compliance costs and, ultimately, consumer costs.

We encourage California to update its invalidation framework in a manner that follows Ontario's approach. Ontario's framework sees some causes of invalidation covered by seller-liability and others covered by an Environmental Integrity Account (EIA). Adopting this improved invalidation framework will remove most invalidation risks from the market, while providing greater incentives to both offset generators and purchasers. The approach also protects the overall environmental integrity of the system.

The buffer pool concept has some regulatory precedent within CARB's existing regulatory structure. **California has endorsed Ontario's improved approach.** When preparing for linkage, Governor Brown's Transmittal Response to CARB on Findings under SB 1018 wrote: *"While Ontario uses a different mechanism to correct any failure or invalidation of an offset, the approach is equally effective...both protect the program in the event that an offset is invalidated."*

A strong approach for designing an EIA, as recommended by the Verified Emission Reduction Association (VERA), would see offset projects required to surrender a percentage (e.g. 3.0%) of issued credits to EIA. This mechanism could be managed similar to the existing California Forest Buffer Account. If offsets are later invalidated – for causes of material overstatement or regulatory non-conformance – invalidated credits would be replaced from the EIA.

2. UNUSED ALLOWANCES AND POST-2020 CAPS

IETA believes the current program is working, as evidenced by the reduction of GHG emissions under the cap. We also believe that a carbon price should send an appropriately strong signal to market participants to continue reducing emissions while investing in abatement.

The current market environment, largely influenced by the recession and aggressive complementary policies, indicates that allowance supply exceeds demand. **However, in reality, the most relevant and robust market analyses indicate that cumulative allowance demand will, in fact, exceed supply** (including banked allowances) before 2030. These findings, consistent with CARB's in-house analysis², signal that the program is not overallocated.³ Therefore, according to extensive research by a variety of analyses – studies produced by academics, consultants, and CARB itself—overallocation is a non-issue that will not hinder California's ability to achieve its legislated 2030 climate target.

In the Supporting Document, CARB requested stakeholder comments regarding uncertainties in its analysis on oversupply. IETA views certain assumptions made by CARB as conservative, in that they result in an overestimate of oversupply. For example, CARB does not explicitly consider the impact of the wider linked carbon market. Ontario and Quebec are estimated to have steeper marginal abatement curves and thereby higher allowance prices compared to California. This implies that future allowances will flow from California to these linked partners and thereby reduce oversupply. **IETA therefore recommends that CARB incorporate estimates for the net import of allowances into its future modeling iterations, in order to further refine its estimation of oversupply.**

As another example, CARB assumes an offset usage rate of 3.0% from 2021 to 2025 and 4.5% offset usage rate from 2026-2030. The Legislative Analyst Office (LAO) reports that regulated entities have used offsets for approximately 5.0% of their aggregate compliance, while noting that new restrictions imposed by AB 398 “will likely decrease the overall number of offsets used for (future) compliance”.⁴ We therefore encourage CARB to incorporate lower offset usage rates into future sensitivity analyses in order to improve the robustness of its current modeling of oversupply.

IETA believes that the current cap, as set pursuant to legislation, should not change. Instead, we feel that CARB should allocate allowances, planned for inclusion in post-2020 Reserve, to Reserve Tiers. This defensible approach will not only achieve future program cost-containment goals, but also help to ease the post-2020 transition to higher prices for compliance entities, households and California consumers.

² See https://www.arb.ca.gov/cc/capandtrade/meetings/20180426/carb_post2020caps.pdf.

³ For example, see Brattle http://files.brattle.com/files/11768_the_future_of_cap-and-trade_program_in_california_final_12.4.17.pdf; ICIS <https://www.icis.com/energy/carbon-emissions/>; BNEF <https://www.bnef.com/core/insights/17155>; and Borenstein et al <https://ei.haas.berkeley.edu/research/papers/WP281.pdf>

⁴ See <http://www.lao.ca.gov/Publications/Report/3719>.

CARB is considering placing 2.0% from 2026 to 2030 allowance budgets into the Reserve. IETA does not support this change. CARB set budgets for the post-2020 program during the 2017 amendment process – a time when the program’s offset usage limit was still at 8.0%. The legislature then lowered the offset usage limit from: 8.0% to 4.0% for 2021-2025; and then to 6.0% for 2026-2030. In both these timeframes, the usage limit becomes more restrictive, which is the opposite of the initial adjustment to the limit from 4.0% to 8.0% to account for the removal of allowances to fill the Allowance Price Containment Reserve (APCR). **To be consistent with its 2010-2011 approach, we feel that CARB should correspondingly increase the post-2020 allowance budgets to account for the new lower offset usage limit.** At the very least, CARB should not exacerbate the impact of AB 398’s tightening of offset usage limits by further removing allowances from the post-2020 market. Not only could higher future prices (resulting from lower supply) reduce broader political and stakeholder support for the program, but inflated prices could also dampen support for alignment and linkage with current and future partner jurisdictions.

The allocation of budgets should be based on strong economic analysis of both short and long-run fundamentals of the program. Budgets should also be established to conform with CARB’s approach to strong, but steadily declining, caps. Any analysis should consider the full scope of the program, including its full now 18-year length (2013-2030) period, the effects of complementary policies, and linkage impacts.

IETA rejects stakeholder suggestions to devalue pre-2021 allowances or place expiration dates on banked allowances. These actions would penalize regulated entities who have already taken early action under the agreement so that they could save allowances for future use. In addition, these (and other) actions would introduce future allowances scarcity, increase compliance costs, and increase costs to consumers.

IETA appreciates CARB’s observation in the Presentation that the relationship between GHG reductions and the carbon price is complex. In particular, it’s critical to recognize that a primary driver of low allowance prices – and thereby oversupply – is the aggressive use of complementary (or “overlapping”) policies to achieve the majority of California’s abatement goals. A more cost-effective strategy to achieve statewide climate goals would be to **de-emphasize the role of these overlapping policies in favor of emphasizing the role of the cap and trade program.** In other words, cap and trade should be recognized and enabled as the “workhorse” policy measure, rather than the “backstop” policy measure, to cost-effectively and measurably achieve statewide climate goals.

3. DESIGN OF COST-CONTAINMENT FEATURES

Staff proposes setting the allowance price ceiling in 2030 at a level between US\$81.90/ton (in 2015 dollars) and \$147/ton. IETA recognizes that the purpose of a hard price is to provide for the continued economic stability and political support of the program. However, many market players have expressed concerns about the proposed price levels, and their underlying assumptions/rationale. Given that allowance prices flow directly through to energy prices, **IETA posits that CARB’s proposed 2030 price**

ceiling range may be too high to ensure allowance prices do not rise to economically and politically unacceptable levels. We strongly encourage CARB to host a series of meaningful, fully-transparent and comprehensive stakeholder consultations related to levels of acceptability and potential implications associated with various price ceiling options.

IETA recommends that the “Reserve Tier” prices (e.g., Price Containment Points or “PCPs”) be spaced more proportionately to allow them to achieve the intended effect of preventing rapidly rising prices in the allowance market. At US\$70/ton (2015 dollars), Tier 1 Reserve price in the first PCP would be over 80% from the floor to ceiling price – a level that potentially increases the risk that the Tier 1 Reserve mechanism may not have time to deliver its desired cost-containment purpose. It could also fail to provide the necessary time for the Independent Emissions Market Advisory Committee to inform stakeholders of options to manage the rising prices. As it’s critical to avoid sparking market instability, IETA suggests that placement of the **Reserves Tiers at price points approximately one-third and two-thirds between floor and ceiling prices** could provide the optimal ability for these points to achieve their intended function.

With regard to the APCR, IETA supports the idea of moving “extra” allowances for 2021 into Reserve Tiers. This would increase the capacity of the Reserve Tiers to mitigate rising allowance prices in the short term and ease the transition to higher prices in the longer term. This is a reasonable and defensible approach to increase supply when prices increase. Putting these allowances in the price ceiling would not support cost-containment since CARB is already implementing a hard price ceiling that allows for the issuance of additional tons.

4. ENSURING ENVIRONMENTAL INTEGRITY

AB 398 directs CARB to maintain environmental integrity by using revenues from the sale of “additional metric tons” at the price ceiling to procure at least equivalent metric ton reductions outside of the program. The sale of these additional tons at the price ceiling indicates that further emissions reductions from capped sectors are more expensive. As such, **IETA believes that CARB should have discretion to procure a broad range of instruments and reductions from projects meeting statutory criteria.**

5. INDUSTRIAL ASSISTANCE FACTORS

IETA supports the proposal to extend the 100% industry assistance factor to provide a smooth transition and address the potential for leakage from California industry. For compliance entities, this approach is important and consistent with the imperative of California’s cap and trade program to minimize environmental and economic leakage. Slide 12 of the Presentation makes apparent the significant increase in compliance costs associated with assistance factors below 100%.

6. ENERGY IMBALANCE MARKET

With respect to the Energy Imbalance Market (EIM), CARB has formally commented to CAISO that: A) supports the proposal to limit the GHG bid quantity of external resources (i.e., quantity that could be deemed delivered to the CAISO) to dispatchable quantity above its base schedule; but B) opposes the proposal to establish a minimum GHG bid price for all external resources. Although the CAISO continues to work on [EIM GHG Enhancements](#), CARB seems to have concluded that the CAISO process will not sufficiently address staff concerns about GHG accounting. Staff reiterated their support for the “bridge proposal”, which sets aside allowances and retires them to account for missing GHG emissions associated with EIM secondary dispatch, and indicated that they are reevaluating the earlier proposal to push responsibility for these emissions to “EIM Purchasers” (i.e., California’s utilities participating in EIM).

Following consultation with affected Members and partners, IETA believes that the “EIM Purchaser” approach fails to offer any substantive benefits over the current bridge solution. We also see that this approach fails to address actual deficiencies in the EIM GHG accounting. We therefore support ongoing engagement with the CAISO, including with respect to how any approach would work in a day-ahead/regional market design, or if other states adopt carbon pricing.

Further, IETA urges CAISO and CARB to provide more details on proposed evaluation approaches and calculations to impact assessment of market operations. This future activity should include more accurate and transparent information regarding the GHG emissions ascribed to secondary dispatch.

In Conclusion

Once again, IETA appreciates this opportunity to comment on CARB’s Presentation and Supporting Document. While moving forward with post-2020 cap and trade amendments and consultations, our community looks forward to closely engaging with Staff.

If you have questions about IETA’s comments, please contact Katie Sullivan, Managing Director, at sullivan@ieta.org.