28 April 2016

To: Rajinder Sahota, Chief
Climate Change Program Evaluation Branch, Industrial Strategies Division
California Air Resources Board, 1001 I Street, Sacramento, California 95814
Online Submission: http://www.arb.ca.gov/lispub/comm2/bcsubform.php?listname=sectorbased3-ws&comm_period=1

IETA COMMENTS ON CALIFORNIA AIR RESOURCES BOARD'S COST-CONTAINMENT WORKSHOP

The **International Emissions Trading Association** (IETA) welcomes the opportunity to share comments on California Air Resources Board (ARB)'s 5 April workshop on potential amendments to California's Cap-and-Trade Regulation related to post-2020 cost-containment and sector-based/REDD+ offset credits.

Please note that our **8 April submission** on international sector-based offsets included our comments on REDD+ from both this workshop and the one held on 22 March. As a result, this submission is limited to cap-and-trade cost-containment.

We welcome the Board and Staff's desire to review and improve-upon the cost-effectiveness of California's existing market-based systems. The following business observations and recommendations to strengthen cost-containment in California's program are structured around: 1) cost-containment as a guiding principle; 2) the important cost-effectiveness of offsets; 3) embracing and building-upon market linkages; 4) avoiding duplicative and non-complementary mechanisms; 5) holding limits and purchase limits; 6) improvements to the Allowance Price Containment Reserve (APCR); and 7) unused allowances.

1. COST-CONTAINMENT AS A GUIDING PRINCIPLE

The distinctive feature of a cap-and-trade program is its ability to **deliver certainty on program outcomes** (i.e., a reduction of greenhouse gas (GHG) emissions) **at least-cost to consumers and businesses.** California's ambitious post-2020 climate targets require significant, cross-sectoral accelerations in deep GHG reductions. Consequently, **it is more important than ever that cost-containment serve as a guiding principle as ARB outlines its climate future**.

Efforts should focus on least-cost abatement opportunities, maximizing the benefits afforded by a healthy trading system, including a broad and vibrant offsets market, and ensuring efficiencies and cross-border market and program alignment.

2. THE IMPORTANT COST-EFFECTIVENESS OF OFFSETS

In light of vocal opposition surrounding the continued inclusion of offset credits in California's cap-and-trade program, IETA believes that it is imperative to emphasize the vital, multi-faceted role that offsets must continue to play in the system.

Offsets as Cost-Containment: Offset credits are a foundational cost-containment component to any functional and flexible carbon pricing program. As part of a robust cap-and-trade system, these credits play a key role in maximizing climate benefits in the least time for a given expenditure, eliminating emissions as efficiently as possible. In addition, including offsets in a cap-and-trade program creates financial incentive for non-market actors that widens environmental consciousness and increases economy-wide emission reduction activities.

Broad access to offsets supports and incents private sector engagement and innovation: Offsets are vital instruments not only in terms of environmental and socio-economic benefits, but also in providing viable prospects for cross-border linkage and collaboration. A broad pool of offsets allows markets to thrive and elicits further efficiencies. Industry relies on wide access to offsets to cost-effectively reduce emissions while maintaining competitiveness. And given differing abatement costs across sectors and regions, the existence of an extensive pool of additional reductions drives cooperation, innovations in clean technology, and reduces the overall price tag for businesses and consumers.

Maximizing the cost-containing potential of offsets: In addition to adopting additional protocols to meet growing post-2020 demand, two relatively simple options could have a sizable impact on the effectiveness of offsets as a cost-containment mechanism without compromising environmental integrity of creating significant additional administrative burden: 1) expand usage limits beyond 8%; and/or 2) allow entities to carry over unused offset limits from one compliance period to the next.

IETA believes that all carbon markets, including California's, should steer away from limiting the use of offsets to a specified percentage of an entity's overall compliance obligation. These subjective limits not only hinder cost-containment opportunities, but also constrain clean innovation and investment and prevent fully eliciting the co-benefits that come from a broad and vibrant offset market. However, given that ARB is not proposing any changes to the quantitative offset usage limit, the system would benefit from amendments to facilitate maximum usage up to the prescribed limit.

Some initial ideas for consideration and future discussion include:

1. Automatic roll-over of unused offset quotas from one compliance period to the next. For those with small compliance obligations, this would allow the offsets limit to grow to an amount sufficient to realize material cost savings by using offsets; and

2. Tradable offset quotas or third-party aggregation. Depending on the design, this could potentially enable aggregation of quotas, while allowing those who prefer to use offsets for compliance to build-up a position to achieve this purpose.

Given that staff is not proposing any changes to the quantitative offset usage limit, California's regulation could be amended to facilitate maximum usage of offsets up to the prescribed limit**. We encourage staff to explore quota design changes to help maximize offsets usage.** Some preliminary ideas for consideration and future discussion include:

- **Roll-Over of Unused Quotas:** Automatic roll-over of unused offset quotas from one compliance period to the next. For those entities with small compliance obligations, this would allow the offsets limit to grow to an amount sufficient to realize material cost savings by using offsets;
- **Usage Limit Tiers**: Creation of offset usage limit tiers based on the size of the covered entities, with limits higher than 8.0% for smaller entities while retaining the prescribed limit for larger entities; and
- **Tradable Quotas and Aggregation**: Allowing for tradable offset quotas or third-party aggregation options. Depending on the design, this could potentially enable aggregation of quotas, while allowing those who prefer to use offsets for compliance to build-up a position to achieve this purpose.

3. EMBRACING & BUILDING-UPON MARKET LINKAGES

Since its launch, the WCI has aimed to guide, support, and facilitate cooperative sub-national climate action, using a linked carbon market as the cornerstone tool. The benefits of linking are clear: the bigger and broader the market, the wider the range of abatement opportunities and improved efficiencies, driving-down program costs while driving-up clean projects, jobs, and investment.

As California develops its post-2020 cost-containment strategy, we encourage officials to embrace, explore, and build-upon market linkages, both across North America and internationally, through the inclusion of international sector-based forestry offset credits. California's trailblazing efforts have created unparalleled expertise at a time when market-based mechanisms have begun to gain traction across a number of North American jurisdictions. The conditions are now ripe for ARB to exercise its leadership and experience to drive critical cost-containment benefits associated with program linkage.

4. AVOIDING DUPLICATIVE & NON-COMPLEMENTARY MEASURES

Non-market measures – such as government incentives, standards, R&D support etc. – can play important roles in helping to reduce emissions, supporting key sectors and technologies, and influencing consumer behavior. But as we have stressed in previous submissions**, complementary measures can**

also create inefficiencies and higher overall program costs if not designed to ensure true and transparent "complementarity" with California's cap-and-trade program.[1]

The absence of "complementarity" leads to the inhibition of market functionality and efficiencies which ultimately serve to stifle California's ability to realize GHG reductions at least-cost. being inhibited

The majority of complementary measures dictate where reductions will occur without changing the total amount of GHG emissions allowed under the cap. Mandating how reductions will be achieved fails to give Californians a clear picture of costs and benefits, while forcing them to finance less economically-efficient solutions with no real impact on state GHG emissions.

For more information on how IETA proposes that complementary mechanism be designed with a focus on maximizing cost-efficiency, see IETA's **Complementary Mechanisms Discussion Paper.**

5. HOLDING LIMITS & PURCHASE LIMITS

At a foundational level, IETA believes that holding and purchase limits amount to artificial market constraints that impede, rather than enhance, program cost-containment, participation and success. Other established and successful commodity markets function without such limits, and we firmly believe that carbon markets should operate no differently.

i) Holding Limits

As we have stressed in previous submissions, IETA's extensive environmental market experience has led to the conclusion that **holding limits are difficult to effectively enforce and have the potential to hinder cap-and-trade programs from functioning at optimal efficiently, leading to higher costs.**[2]

Problematic issues with the holding limit were identified as early as February 2012 when the California Legislative Analyst's Office observed: "By their nature, holding limits are somewhat arbitrary and inflexible. Moreover, it is possible that the risk of carbon market manipulation may be overstated. Other types of markets involving the trading of commodities function well without holding limits."[3]

In addition**, holding limits impede the ability of entities with low-cost financing to offer this capital to the market**, thereby lowering the carbon inventory financing costs available to covered entities. By making these sorts of transactions unnecessarily onerous and reducing the opportunity for them,

[1] See for example, *IETA Comments to California Air Resources Board (ARB): 2030 Scoping Plan Update & Economic Analysis Workshop*, submitted 29 January 2016

[2] See for example, *IETA Comments on California Air Resource Board's Potential 2016 Amendments to Cap-and-Trade Regulation*, submitted 19 October, 2015.

[3] Mac Taylor, Legislative Analyst's Office, *Evaluating the Policy Trade-Offs in ARB's Cap-and-Trade Program*, 9 February, 2012, pg. 23.

holding limits effectively lead to higher costs of capital for covered entities, thus increasing indirect costs passed on to consumers.

IETA would urge ARB to consider removing holding limits to optimize program flexibility and lower compliance costs for covered entities. In the absence of removal, **we recommend instituting suitable flexibility to address the unintended consequences and market distortions resulting from holding limits.** Such flexibility could be achieved through approaches including, but not limited to: 1) exempting certain types of transactions from the quantitative holding limit; providing a longer grace period for rectifying holding limit exceedances; and/or allowing for varying holding limits depending on the nature and obligations of certain participants.

ii) Purchase Limits

IETA equally opposes the use of auction purchase limits, as we believe that they unduly hamper the ability of for large covered entities to cover and cost-effectively manage their compliance obligations. Limits also unfairly skew the market and limit participation by preventing entities with smaller compliance obligations from engaging in transactions.

6. IMPROVEMENTS TO THE ALLOWANCE PRICE CONTAINMENT RESERVE (APCR)

IETA supports amendment of the 2020 APCR by both reducing Reserve Tier prices and eliminating the 5% increase in Reserve Tier prices mechanism until a Reserve auction has been triggered by entities purchasing at the Auction Reserve Tier prices, at this point, ARB could consider readopting a 5% price increase mechanism on a go forward basis to mitigate risk of full depletion of the Reserve.

By implementing Option 2 of ARB's 29 March Workshop on potential amendments to California's Cap-and-Trade Regulation in relation to post-2020 emissions caps, the 2021 cap will be adjusted to align with California's 2020 emissions level. IETA recommends that the allowances associated with this "adjustment" should be directed into the Reserve. By allocating these allowances into the Reserve, the program would support a sustained price signal, the prevailing Reserve Tier prices, without creating potential price spikes to unacceptable levels that could occur if the Reserve was fully depleted. The diversion of the allowance "adjustment" into the Reserve will bolster Reserve volume, supporting the reduction in the current Reserve Tier price levels without increasing the risk of full Reserve depletion and resulting market price level issues.

IETA cautions ARB on adopting allowance borrowing into the California cap-and-trade program. ARB is currently modifying the cap-and-trade program to align with the Clean Power Plan for future SIP submission. Incorporating borrowing into the program would be contrary to this effort and create additional complexity that is unnecessary in providing an appropriate cost containment mechanism for the program. Additionally, this type of program design could create dysfunctional market behavior by

borrowing allowances from future periods that have a program short that is more significant than the compliance periods that these borrowed allowances would be applied to. This condition could lead to unacceptable price levels in these future years due to burden shift to later years stemming from this mechanism.

7. UNSOLD ALLOWANCES

The current mechanism for dealing with allowances in an undersubscribed auction effectively suspends the sale of these allowances until the demand in the market supports their injection. **IETA recommends that this mechanism be maintained in its current form.** It is supportive of a healthy trading system, suspending the sale of allowances until a period of time when demand warrants their sale. By either including these allowances in the APCR or retiring them, the program risks incenting market behavior that is decoupled from fundamentals, and could cause short-term pricing volatility. This could remove the appropriate long term pricing signals needed to incent the adoption of emission reduction technology by forcing participation in advance of fundamental support. Entities may be financially incented to remove the risk of severe allowance shortages at current pricing levels, a result of removing these allowances from the market altogether or until the pricing level is much higher than the current market.

IETA recommends that allowances in the Reserve at the end of 2020 should be carried forward and remain in the Reserve for future purchase. As ARB highlighted on page 6 of their presentation, if the Reserve were to be depleted, prices could rise to unacceptable levels and administrative intervention in the market may need to occur. The risk of depletion and the resulting impacts to the market are greatly reduced by carrying the current Reserve allowances into the post-2020 timeframe.

In Conclusion

IETA appreciates this opportunity to record our comments related to post-2020 cap-and-trade program cost-containment. Our multi-sector business membership remains committed to supporting the successful evolution of flexible market mechanisms to help achieve California's ambitious future climate goals at least-cost.

If you have questions, or further clarification related to this submission, please contact IETA's Director of the Americas, Katie Sullivan (**sullivan@ieta.org**).

Sincerely,

Dirk Forrister
IETA President and CEO