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Rajinder Sahota, Chief
Climate Change Program Evaluation Branch, Industrial Strategies Division
California Air Resources Board
1001 I Street, Sacramento, California 95814
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IETA COMMENTS ON CALIFORNIA AIR RESOURCES BOARD'S POTENTIAL 2016 AMENDMENTS TO CAP-AND-TRADE REGULATION

On behalf of the International Emissions Trading Association (IETA), we appreciate the opportunity to provide initial comments to the California Air Resources Board (ARB)'s on Potential 2016 Amendments to California's Cap-and-Trade Regulation. IETA supports California's climate policy leadership, use of flexible market-based tools, and ongoing cooperation with other jurisdictions to address competitiveness concerns while cost-effectively reducing greenhouse gases.

We welcome ARB's desire to review and improve-upon its existing cap-and-trade program rules and procedures. We understand that staff is seeking broad comments at this time, and that stakeholders will have the opportunity to delve deeper into individual topics and proposed amendment via future fora (e.g., workshops, webcasts, submissions etc.) and other proceedings. IETA's initial comments into the public process on potential amendments cover the **following priority topics:**

1. OFFSETS

A. Develop well-defined, transparent procedures and timelines for all project reviews/issuances.
B. Revise offset usage limits to facilitate maximum use to the defined limit.
C. Improve invalidation approach; or, at the very least, clarify investigation process and timelines.
D. Establish multi-sector "collaborative mechanisms", such an advisory panel and working group(s).

2. MARKET INFORMATION & REGISTRATION

A. Limit information required to participate in the program to that which is *necessary*.
B. Standardize market monitoring approach to be *more robust* and *less onerous*.
C. Simplify transaction process through a *seller-generated, single sign-on* transfer process.
D. Consider initial batch of auction process and streamlining considerations.
E. Eliminate domicile requirement.
F. Allow affiliates operating in multiple jurisdictions to aggregate accounts.

3. OTHER PRIORITY ITEMS:

A. Modify approach to holding limits to be less onerous and more workable; and
B. Remove ambiguity regarding RPS Adjustment program and related REC accounting issues.

1. OFFSETS

A. Develop well-defined, transparent procedures and timelines for all project reviews/issuances.

A paramount concern to ensure offset program functionality and efficacy is to clearly define the offset project review and credit issuance process, including timelines and regulatory compliance requirements. Under California's current regulation, developers frequently do not have consistent timeframes for evaluation of their projects. The current process allows ARB a 45-day review period, from the date completed materials are received, subject to a restart of the 45-day window each time ARB asks for and receives additional information. In its 2016 amended regulation, we encourage ARB to adopt a more efficient, straight-forward approach, which more closely engages developers and OPRs to achieve success.

First, **any offset application be approved or rejected within a noticeably shortened – we suggest, 30-day – period**. Rejected applications may be re-submitted subject to correction of missing material and/or data as determined by the reviewer, starting another review 30-day review period. This improved approach would lighten the burden on ARB by placing the responsibility on the applicant to reinitiate the process. It also provides the applicant with a better sense of process timing.[1] A further step for consideration is to require an initial ARB-applicant "scoping meeting" that sees Q&A and an opportunity for applicant feedback, either prior to or at the outset of the review period.

Second, ARB could **allow OPRs to essentially act as surrogates to the agency throughout the review process**. Understanding that the review process can be administratively burdensome to ARB, the process could be facilitated through heavier reliance on, and empowerment of, OPRs.

B. Revise offset usage limits to facilitate maximum use to the defined limit.

IETA believes that all carbon markets, including California's, should avoid limiting the use of offsets for compliance purposes to a specific percentage of an entity's overall obligation. These subjective quantitative limits restrict cost-containment opportunities and other benefits (e.g., linkage, socio-economic co-benefits etc.) that underpin a broad and vibrant offset market.

In California, a covered entity can only meet up to 8.0% of its compliance obligation (per compliance period) using offsets. Today, many covered entities with smaller compliance obligations are typically incapable of making full use of offsets. This is typically due to transactional and informational barriers to the purchase of small quantities of offsets, such as contracting costs and due diligence requirements, being perceived to outweigh the benefits. Consequently, the full use of offsets (up to the defined limit) rarely, if ever, materializes.

To the extent that California chooses to maintain an offset usage limit at the current level, 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.

C. Improve invalidation approach; or, at the very least, clarify investigation process and timelines.

California and Quebec have different mechanisms for handling the risk that an offset may be invalidated post-issuance. In its amended 2016 regulation, **IETA recommends that California consider adopting an approach similar to Quebec's Environmental Integrity Account (EIA) mechanism.** IETA welcomes future opportunities to expend on this recommendation and define looming risks and program impacts with California's current approach, many of which have been described at length in previous IETA communications with ARB.

We also **recommend that amended regulation provide heightened clarity on ARB's invalidation investigation timing, process and overall communications with stakeholders**, including parties who are not directly affected by the invalidation activities. Amendments should provide specific deadlines for action on potential invalidations in order to provide market certainty to the process. Under current regulation, it appears that an invalidation decision (invalidate vs. restore affected offsets) is required within a two month time frame.[2] However, during the 2014 Clean Harbors' ODS investigation case, officials delayed findings and the "final determination" took *over six months*. During the lengthy Clean Harbors' investigation period, market participants were provided limited information or explanations related to timing, process, and potential outcomes.

Finally, as noted in recent communications from IETA and other stakeholders[3], we also encourage ARB to clarify – through additional guidance and/or harmonizing language across the regulation and compliance offset protocols - the **definition and boundaries for determining regulatory compliance** for projects.

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[2] *See ARB Regulations, Section 95985(f)(2) (providing parties 25 days to respond to an initial notice), and 95885 (f)(4) (providing the administrator 30 days to make a final determination of invalidation).*

[3] *See June 19, 2015 IETA letter to Richard Corey, "Requesting Clarity on Regulatory Compliance" and September 28, 2015 ACR to Richard Corey, "ODS Offset Protocol, Invalidation Guidance".*

D. *Enable and formalize "collaborative mechanisms" to support California's offset program.*

Based on mounting evidence, we see that certain elements of California's offset program are proving difficult to efficiently manage and execute. Based on IETA's experience and engagement with regulators across a range of offset programs worldwide, we believe that some of California's current offset implementation challenges can be properly assessed and ameliorated – provided the proper support mechanisms and additional multi-sector resources are provided to ARB.

We suggest California's amended regulation allow for the creation of new offset support mechanisms, such as a Multi-Sector Offsets Advisory Panel and Offsets Technical Working Group(s). Initial thoughts on the potential role and mandates for these "collaborative mechanisms" are summarized below.

- **Multi-Sector Offsets Advisory Panel** would include regional and international policy, business and market experts from a range of sectors, including: academia, think thanks, industry, and the non-governmental community. Panel members would work closely with ARB staff to review the current Offset program, identify potential challenges or constraints, while offering expertise to inform analytics. The process and feedback from the Panel would inform constructive program improvements for 2020, 2030 and beyond. The multi-sector panel reviews and recommendations would be supported by rigorous analysis/modeling and transparent communications. Panel participants would be carefully selected to ensure objective perspectives and practical expertise to improve the efficient operation of California's market.

- **Offsets Technical Working Group(s)** would consist of experienced professionals from a range of relevant sectors and work with ARB Staff to understand and analyze the practical implications of implementing changes to ensure the continued growth and success of California's nascent market.

2. MARKET INFORMATION & REGISTRATION

Carbon markets, like other commodity markets, should be built on clear, concise rules and critical oversight mechanisms. Market regulation and requirements must preserve program integrity and confidence, while enabling – rather than hindering – market participation and liquidity. Guided by robust and efficient market design fundamentals, we recommend that ARB consider modifying several participant, trade and auction information requirements as part of its regulation amendment process.

A. *Limit required information to participate in the program to that which is necessary.*

Both California and Quebec currently require registrants in the Compliance Instrument Tracking System Service (CITSS) to provide extensive corporate and personal information in order to participate in the cap-and-trade system. In both jurisdictions, simply registering or naming a new account representative is time consuming, and approval of the submission takes significant resources. Even greater detail, with similar hurdles, is required to be submitted to participate in each auction. All information submitted to CITSS must also be updated immediately upon (even the most minor) corporate changes, creating the potential for a registrant to be in technical violation of registration requirements due to potentially insignificant – or at times irrelevant – changes in corporate structure. As a general matter, this required information is *well beyond the scope of that required to participate in other commodity markets.* In the amended 2016 regulation, **IETA urges California to revisit the information required to the minimum necessary to both operate and monitor a fair, open and ultimately effective market.**

The recently-issued US Environmental Protection Agency (EPA) Final Rule on Greenhouse Gas Emissions from existing power plants (Clean Power Plan) provides a useful contrast to WCI/CITSS existing information requirements and process. Under the Clean Power Plan, EPA requires a much more minimalist slate of requirements to register and participate in allowance markets. Given EPA's 35-year experience in managing markets for the trading of emissions-related instruments, the federal Agency's judgment with regard to requirements for registration of market participants should be considered a sound template for how best to structure such requirements.[4]

B. Standardize market monitoring approach to be more robust and less onerous.

IETA's overarching priority is a well-functioning market, and we support a vigilant and stringent regulatory enforcement regime to prevent market manipulation. However, in many respects, California has imposed a regulatory regime overseeing its cap-and-trade program that is unnecessarily complex and administratively burdensome. Specific examples of current disclosure requirements that should be revisited in 2016 amendments include:

- **Employee Information Disclosure**: California requires participants to report the names and contact information for any and all employees that have knowledge of the registrant's market position. In some cases, this requirement translates into virtually *all employees at the company*. Requiring this information can be incredibly costly to implement, overly burdensome, and simply unnecessary.

- **Consultant & Advisor Disclosure**: California requires disclosure of any "consultants and advisors" that assist on a broad range of issues – *many of which have nothing to do with the carbon market*. As we understand, this requirement is in place so California can ostensibly monitor the possibility that market information may somehow be improperly shared. However, these types of rules are neither necessary nor constructive. The current requirements also work to dramatically limit third-party expertise and vital professional services available to the growing market.

By way of comparison, it is worth noting that **Quebec has not adopted market monitoring practices similar to California's onerous approach**. The provincial rules are generally straight-forward in this regard: Quebec's regulations make it illegal to trade emission allowances based on privileged information,

[4] *The Regional Greenhouse Gas Initiative (RGGI) cap-and-trade market provides another example for California to consider.*

improperly disclosed information, or false or misleading information[5]. Armed with a similar broad-based regulatory principle, California regulators should be fully capable of policing the market as necessary, without the highly specialized roster of specific prohibitions and requirements currently in place.

Although some unique differences in carbon markets may exist, the underlying issues in commodity markets regarding transparency and market power are in common. **California's regulation should be amended to reflect market monitoring requirements that more closely reflect those implemented by Quebec, the US EPA (for environmental commodities within its jurisdiction), and the CFTC for general commodity trading.**

C. Simplify transaction process through a seller-generated, single sign-on transfer process.

Under most commodity markets, including other cap-and-trade systems, transactions are completed virtually instantaneously when a single representative of the selling entity enters the transaction into the tracking system. No approval is required by a second representative of the seller, by a representative of the buyer, or by the market regulator. Examples of this system include RGGI's CO2 Allowance Tracking System (COATS) and Allowance Tracking System used by the EPA's Cross-State Air Pollution Rule (CSAPR) market.

In California, by contrast, the regulation creates an unwieldy and complex system requiring: 1) initiation of a transaction by one of the Seller's account representatives; 2) confirmation by a second Seller's account representative within 2 days of initiation; 3) a subsequent confirmation by a representative of the receiving account, done within 3 days of initiation of the transaction; and 4) review by the executive officer.[6] Further, failure to complete a transaction within the stated time frame (e.g., if the Seller's second representative was unexpectedly out of the office for 2 days, or the seller's representative was unavailable on the third day) can subject both parties to be deemed in violation of the regulations and subject to penalties.[7]

The current process is not only unnecessary, but causes parties to incur significant administrative costs without commensurate benefits. It also raises questions regarding compliance instrument ownership and liability during the period between the time the seller submits the transfer and is ultimately approved in the system; the translates into substantial contractual uncertainty that inhibits the efficient trading of allowances in commodity markets.

D. Auction process and streamlining considerations.

California's cap-and-trade program could be improved by streamlining the auction process information requirements and timetables. Some initial observations and potential areas of improvement include: 1)

5 See Quebec Rules 28-31. In essence, this applies the same terminology as contained in the Quebec Securities Act (Section 191.1) and Derivatives Acts (Section 145.1).

6 See ARB Regs 95921(a)(1))

7 See ARB Regs 95921(a)(4)

Reducing the number of days between application and bid guarantee deadlines; 2) Removing the notification of intent to bid requirement; and 3) Streamlining the financial settlement process. IETA is happy to expand on these recommendations, and more, in future formal and informal communications with ARB staff.

E. Do not require participants to maintain an individual domiciled in their jurisdiction.

Both California and Quebec require that cap-and-trade participants have an agent for service of process within their jurisdiction, satisfying requirements that they are doing business within the jurisdiction and subject to laws of the jurisdiction. Both jurisdictions also require program participants to maintain an Account Representative domiciled in their jurisdiction.

Requiring a company to ensure an employee is domiciled in a specific state or province adds limited (if any) value to the jurisdiction, as the company would already be fully subject to the jurisdiction's laws and service of process. However, it subjects the company to new sets of unfamiliar laws and regulations that can make it cost-prohibitive to engage in trading. **Without a clear and strong rationale to maintain this domicile requirement, we recommend it be deleted in the amended 2016 regulation.**

F. Allow affiliates operating in multiple jurisdictions to aggregate accounts.

California and Quebec currently allow multiple affiliates from the same company to register in their jurisdiction. They also allow affiliates within a given jurisdiction to maintain consolidated accounts for trading purposes. However, where an entity has affiliates in multiple linked jurisdictions, current California regulations require that the accounts be disaggregated and maintained separately. Quebec regulations do not have a similar requirement. Limiting the ability of affiliates to undertake intra-corporate transactions in this manner serves little purpose, but can drive-up compliance and operating costs.

For example, consider a parent company that owns three manufacturing businesses, with two in California and one in Quebec, each of which has a compliance obligation. Under California's current regulations, the two California entities are able to aggregate their accounts, allowing the affiliates to work together to reduce overall compliance costs. The Quebec entity, by contrast, would be required to be disaggregated from its affiliates, and maintain an entirely separate account. This requirement seems to provide little additional regulatory protection, yet may significantly increase compliance costs.

We recommend that ARB amend regulation to allow for cross-jurisdiction accounts with linked jurisdictions. As more jurisdictions seek to link with California, this proposed revision will become increasingly important.

3. OTHER PRIORITY ITEMS

As California explores potential 2016 amendments that could affect the program's important third compliance period and post-2020 program participation and activity, a series of additional items warrant priority attention by ARB. IETA welcomes future opportunities to engage with ARB on these priority items, summarized below, relating to the design of California's holding limits and RPS Adjustment Program.

A. Modify approach to holding limits to be less onerous and more workable.

Based on broad and deep environmental market experience and evidence, IETA believes that holding limits are difficult to effectively enforce while potentially impeding the proper functioning of a cap-and-trade program.

Under its 2016 amended regulation, **ARB should consider removing holding limits** to avoid unintended consequences and ensure the program provides flexibility necessary to achieve the lowest possible costs of compliance. This observation particularly holds true for large market participants, whose holding limits may at times be lower than their compliance obligations.

In addition, **holding limits impede the ability of entities with lowest-cost financing** to offer competitively priced capital to the marketplace. These entities provide certain exchange-cleared allowance transactions that allow California covered entities to take advantage of lower capital/borrowing costs from the market, thereby lowering their carbon inventory financing costs. These types of transactions are commonplace in many physical commodity markets, but are difficult to transact on a regular basis because of holding limit restrictions. The consequence of holding limits therefore becomes: fewer opportunities for these types of transactions; higher costs of capital for covered entities; and increased indirect costs for consumers and ratepayers.

Should ARB be unwilling to remove holding limits in future regulatory amendments, **we recommend instituting suitable flexibility to address the unintended consequences and market distortions resulting from holding limits.** Such flexibility could be achieved through approaches such as, *but not limited to*:

- 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.

B. Revise regulation related to the RPS Adjustment program, along with the related issue of REC serial number reporting associated with imported power from specified sources.

Under current regulation, if an entity delivers power into California and Renewable Energy Credits (RECs) were created by the generation of that power, the "direct deliverer" is required to report the associated REC serial numbers to ARB. This regulation fails to contemplate that the "direct deliverer" may not be the owner of the RECs, and therefore have no legal right to the information about associated RECs. What's more, the "direct deliverer" may not even be aware about whether or not such RECs in fact exist. As such, the requirement as currently written is unworkable, and we recommend **the provisions be eliminated in conjunction with a stakeholder process to explore more effective options to address the perceived underlying need.**

When considering program amendments, we believe it fair to ask ARB to uphold the following principles: changes must prevent double-counting and improve implementation; and align REC ownership with environmental attributes of electricity[8]. As articulated by ARB staff during the 2 October public workshop, the 2014 reporting year saw several cases in which two entities claimed the renewable attributes for a generation source; a situation that potentially stems from how entities interpreted the RPS Adjustment and specified source requirement provisions under the cap-and-trade regulations (including MRR) rather than a problem inherent to the RPS Adjustment itself.

IN CONCLUSION

Once again, IETA appreciates this initial opportunity to record our comments related to Potential 2016 Amendments to California's Cap-and-Trade Regulation. Our multi-sector membership remains committed to supporting the successful growth and evolution of a fully-functional, linkable California carbon market to help achieve the state's climate goals in a cost-effective manner.

If you have any questions about these comments, or further clarification is required, please do not hesitate to contact IETA's North America Director, Katie Sullivan, at sullivan@ieta.org.

Sincerely,

Dirk Forrister
IETA President and CEO

ABOUT IETA: *For over 15 years, IETA has been the leading global voice of the business community on the design, implementation and evaluation of flexible mechanisms to harness the true power of markets and private sector innovation to tackle climate change. Worldwide, our team and multi-sector membership work closely with governments (sub-national, national, and UN levels), multi-laterals, leading academics, and environmental groups to inform the design, expansion and overall functionality of these critical mechanisms. Our 140+ member companies include some of North America's, and the world's, largest power, industrial and financial corporations, including leaders in oil & gas, electricity, manufacturing, mining, chemicals, and paper. Members also include leading firms in: data assurance and certification; brokering, trading, and finance; engineering and clean technology; offset project development, aggregation, registries; and legal and advisory services. For more information, visit www.ieta.org*

[8] *RECs developed with the explicit purpose of ensuring an accurate ownership and accounting of the renewable attributes of power. Under REC accounting, if the physical electricity and the associated RECs are sold separately, the electricity is no longer considered "renewable" or "green". Clearly aligning the regulations with REC ownership will prevent double-counting.*