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IETA COMMENTS ON CALIFORNIA AIR RESOURCES BOARD WORKSHOP POTENTIAL 2016 AMENDMENTS TO CAP-AND-TRADE REGULATION

On behalf of the **International Emissions Trading Association** (IETA), we appreciate the opportunity to provide comments on California Air Resources Board (ARB)'s 24 February **Workshop on Potential Amendments to California's Cap-and-Trade Regulation**. We welcome the Board and Staff's desire to review and improve-upon California's existing market-based systems and offer a series of recommendations, structured around: 1) offset program improvements; 2) market information and registration improvements; and 3) holding limit design improvements.

1. OFFSET PROGRAM IMPROVEMENTS

California's ambitious 2030 and longer-term climate targets require *significant*, cross-sectoral accelerations in deep greenhouse gas reductions. **Cost-containment benefits afforded by a healthy trading system, including a broad and vibrant offsets market, will become increasingly critical for California post-2020.** The following reflect business observations and recommendations specific to improving the functionality and enhancing confidence in California's future offset program.

A. Develop well-defined, transparent procedures and timelines for review & issuance process.

Under California's current regulation, project proponents/developers typically do not have clear and consistent timeframes from ARB with respect to reviews and issuances. Currently, the process allows ARB a 45-day review period (from the date completed materials are received), then 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 and straight-forward approach; an approach that more closely and transparently engages developers and OPRs to achieve success.

B. Eliminate invalidation approach; or, at the very least, clarify investigation process and timelines.

California and Quebec currently 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.** 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.

C. *Improve clarity and consistency of regulatory compliance language*

IETA encourages ARB to clarify the **definition and boundaries for determining regulatory compliance** for projects. This could be addressed by clearer, more harmonized language across the amended regulation and compliance protocols, as well as the issuance of additional guidance. Moreover, regulatory compliance language should be revised so that a material violation or issuance of non-compliance results in a loss of offsets only for the period of non-compliance – not across the entire reporting period.

D. *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. In California, a covered entity can only meet up to 8.0% of its compliance obligation (per compliance period) using offsets – although many covered entities, particularly with smaller compliance obligations, are currently 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 usage level, 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.

2. MARKET INFORMATION & REGISTRATION IMPROVEMENTS

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. 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.**

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

IETA supports a vigilant and stringent regulatory enforcement regime to prevent market manipulation. Unfortunately, in many respects, California has imposed a regulatory regime that oversees its cap-and-trade program, which is unnecessarily complex and administratively burdensome. Examples of current disclosure requirements that should be revisited in 2016 regulation 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*. 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.

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), and the CFTC for general commodity trading.

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

In 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.

By contrast, California's 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 three days of initiation of the transaction; and 4) review by the executive officer.[1] 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.[2]

The current process is unnecessary and 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 – a situation that translates into substantial contractual uncertainty that inhibits the efficient trading of allowances.

D. 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.**

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

[1] *See ARB Regs 95921(a)(1))*
[2] *See ARB Regs 95921(a)(4)*

3. HOLDING LIMIT DESIGN IMPROVEMENTS

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 various approaches, such as:

- 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.

IN CONCLUSION

Once again, IETA appreciates this opportunity to record our comments related to ARB's workshop on Potential Amendments to California's Cap-and-Trade Regulation. Our multi-sector membership remains committed to supporting the successful growth and evolution of California's carbon market to cost-effectively achieve the state's ambitious climate goals to 2030 and beyond. If you have any questions about these comments, or further clarification is required, please do not hesitate to contact IETA's Director of the Americas, Katie Sullivan, at sullivan@ieta.org.

Sincerely,

Dirk Forrister
IETA President and CEO