CARBON MARKET COMPLIANCE ASSOCIATION

Wednesday, January the 10th, 2017

Via *Electronic Submittal*

Ms. Rajinder Sahota
Assistant Division Chief
Industrial Strategies Division
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: CMCA INITIAL COMMENTS ON NEXT STEPS FOR THE POST-2020 CAP AND TRADE REGULATION – IN RESPONSE TO THE AIR RESOURCES BOARD'S WORKSHOP ON OCTOBER 12th, 2017

Dear Ms. Sahota:

The Carbon Market Compliance Association ("CMCA") is a non-profit organization consisting of compliance entities and market participants involved in the Western Climate Initiative ("WCI") Cap and Trade program that includes many entities with compliance obligations in California, Ontario and Quebec. Founded in 2014 and with over 25 members today, the 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 is a strong supporter of California's greenhouse gas (GHG) emissions reduction goals and the Cap-and-Trade ("C&T") Program and appreciates the opportunity to provide comments to CARB. Specifically, CMCA is providing initial comments on the post-2020 C&T regulation and the implementation of AB 398 in response to the recent workshop conducted by CARB on October 12th, 2017. CMCA convened a stakeholder group of compliance entities, market participants, and interested stakeholders including non-CMCA members, which met weekly starting in September 2017, to focus on issues that are very important to ensuring a successful long-term market-based program to reduce emissions and meet California's admirable environmental goals. CMCA recognizes that climate change is a critical threat to the economy, environment and public health of California. It is imperative that the C&T Program play a significant role in reducing emissions to meet the targets laid out by SB-32 and the Draft Scoping Plan in a cost effective and economically efficient manner.

The comments provided in this letter are a reflection of the issues where CMCA members who participated in the discussion group reached a general consensus and this document only references CMCA members consensus viewpoints. This stakeholder group also reached out to a number of economists and other stakeholders impacted by the C&T Program and this "consensus" does not necessarily reflect their views or the views of non-CMCA members who participated.

1. ***PRICE CEILING:***

AB-398 requires that CARB establish a price ceiling and that certain prescribed considerations be used in establishing the price ceiling. CMCA believes that CARB should also consider the potential impact upon linked jurisdictions when establishing the price ceiling.

CMCA recommends that the minimum price ceiling starting point in 2021 be at least $50/ton (in absolute dollars, not relative to the floor price) and be above the estimated social cost of carbon in 2030 such that rational economic decisions are made by the market.

The price ceiling point in 2021 should be no higher than $80/ton (in absolute dollars, not relative to the floor price) for the following reasons:

- To minimize adverse impacts on the California economy and jobs.
- To minimize economic and environmental leakage when considering the level of assistance (direct allocations) provided to covered entities.
- To avoid threatening the long-term viability and support for the cap and trade program within the WCI and other jurisdictions with which it might link in the future.

CMCA recommends that ARB maintain a constant spread between the floor and the ceiling roughly through 2030. CARB could reconsider the appropriate ceiling level and rate of increase post 2030 in later scoping plan updates.

2. PRICE CONTAINMENT POINTS:

AB-398 also requires that CARB establish certain price containment points. Depending on the final level chosen by ARB for the ceiling price, CMCA recommends that the price containment points should be equidistant between the auction reserve price and the price ceiling as long as this equates to a starting point for the first Price Containment Point above $30.

It is important the Price Containment Points be used to send appropriate market signals, mitigate extreme price volatility and provide a trigger point for the legislature and stakeholders to review the program parameters. If the price containment points are set too close to the auction reserve price they will unduly dampen prices early on while removing protections later in the program. Conversely, as CARB pointed out when it proposed collapsing all three tiers of the APCR into one in the 2016-2017 regulatory amendment process, the price containment points are ineffective if set too close to the price ceiling or too close to each other.

Volume of allowances in the price containment points:

It was the consensus of the CMCA stakeholder members and some of the market experts with whom we consulted that CARB should attempt to reinforce the price containment points by putting in additional allowances over which CARB has discretion. Additional allowances could be provided by ARB in the price containment points through including:

- Post-2020 APCR allowances previously set aside and taken out of budget years 2021 to 2030.
- Unsold allowances that revert to the APCR after 24 months being unsold.
- Any allowances from reduced annual budgets that CARB may determine through the regulatory process to further address perceived oversupply concerns.

Additionally, ARB should evaluate employing the "borrowing" mechanism currently in the regulations to reinforce the volumes in the price containment points if such a mechanism is deemed appropriate.

3. DISTRIBUTION MECHANISM FOR SALES AT THE PRICE CEILING AND THE PRICE CONTAINMENT POINTS:

AB 398 provides only limited direction on how allowances at the price containment points and price ceiling should be sold:

> *"To implement the price ceiling, the state board shall develop a mechanism that consists of both of the following: Allowances remaining in the allowance price containment reserve as of December 31, 2020, shall be utilized solely for the purpose of sale at the price ceiling established by this section. If the allowances from the allowance price containment reserve are exhausted, the state board shall offer covered entities additional metric tons at the price ceiling if needed for compliance."*[1]
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> *"Establish two price containment points at levels below the price ceiling. The state board shall offer to covered entities nontradable allowances for sale at these price containment points. The price containment points shall be established using two-thirds, divided equally, of the allowances in the allowance price containment reserve as of December 31, 2017."*[2]

CMCA believes that the current APCR sale process could provide a starting framework to sell allowances at these price containment point levels. Specifically, CARB should use a sale process, similar to the current Reserve Sale, which provides entities the opportunity to purchase allowances at these specific price containment point levels at least once a year and prior to each compliance surrender deadline.

Reserve Sales are held quarterly after the regular quarterly auctions. Beginning in 2021, the first, second, and final Reserve Sales scheduled for each year will only be offered if the

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[1] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180AB398 *[s38562(c)(2)(A)(ii)(I-II)]*
[2] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180AB398 *[s38562(c)(2)(B)]*

Current Auction held in the preceding quarter results in an auction settlement price greater than or equal to 60% of the APCR sale price (e.g., if the APCR price were $80 in 2021, then those Reserve Sales would only be held if the Current Auction clearing price of the preceding quarter were greater than or equal to $48). Regardless of price, though, the third reserve sale each year is always held.

__Modified Reserve Sales to Accommodate Price Containment Point Sales__

CMCA recommends that the Reserve Sales structure be modified once the price containment point levels are determined, so that Reserve Sales are held only if the preceding Current Auction clearing prices are greater than or equal some percentage of the relevant price containment point price (e.g., if the first price containment point were $36 in 2021, then the Reserve sale associated with that point would be held if the Current Auction clearing price were greater than or equal to $21.60), and similarly for the second price containment point and price ceiling structures. Regardless of price, though, the third reserve sale each year is always held in order to provide a compliance option in cases of low market liquidity or availability.

The purpose of the sale of allowances at the price containment points and the price ceiling is cost-containment for compliance with the program. Therefore, it is important that entities be offered the opportunity to purchase allowances at those prices prior to compliance deadlines. Adequate time and opportunity for purchase should be given to minimize the risk of non-compliance and the process should be kept simple and consistent across jurisdictions.

CMCA believes that in contrast to the current APCR structure, the price containment points should be more widely distributed and that there should be a separate Reserve Sale for allowances from each price-containment point, since entities can buy additional allowances at subsequent auctions or in the secondary market. (I.e., if prices rise to the trigger point for the first price containment point, then only allowances from that first price containment point would be offered at that Reserve Sale). If Current Auction clearing prices are greater than or equal to the trigger price for the second price containment point, the Reserve Sale would also offer allowances at the second price containment point. If there is more demand than supply for allowances at the first and second price containment points, CARB would allocate them pro-rata based on entities' bids, as APCR allowances are treated in current regulations.

While CMCA believes that that this same mechanism could be used for the ceiling allowances, ARB might need to consider some additional tracking mechanism to differentiate between allowances available at the ceiling and additional instruments made available at the ceiling price once allowances are exhausted.

With regard to whether covered entities can buy additional metric tons at the price ceiling, the language "*if needed for compliance*" should be self-defined (with compliance entities determining need), since compliance entities would seek to minimize the number of instruments they buy at the price ceiling. CMCA recommends that instruments bought from the price containment points and price ceiling sales go directly into an entity's compliance account.

The price ceiling and price containment point sales should be open to covered entities and opt-in covered entities in California and linked jurisdictions. Otherwise, at higher prices, more tradable instruments will transfer to linked jurisdictions, and California entities would end up purchasing more non-tradable instruments. Allowing broader participation could avoid this market segregation between tradable and non-tradable instruments.

4. ***MAINTAIN ENVIRONMENTAL INTEGRITY WITH FUNDS COLLECTED AT THE PRICE CEILING:***

Regarding the use of funds collected by CARB at the ceiling price, CMCA recommends that by default CARB can purchase Air Resources Board Offset Credits ("ARBOC") and other WCI Linked Jurisdictional Offsets in order to meet the 1-for-1 reduction requirement set out in the legislation. Additionally, if CARB expands the definition of ARBOCs to include REDD or other new protocols these would also, by default, qualify as eligible instruments. Additionally, the one-way linkage mechanism established in the adopted 2017 amendments whereby ARB may purchase compliance instruments from other jurisdictions could also qualify as eligible instruments, as long as such were approved by ARB.

While CMCA expects that ARBOCs will likely provide the bulk of the instruments used by CARB to satisfy the 1-for-1 reduction requirement, CMCA feels that it is important for CARB to not presuppose the outcome and outline a path for other reductions to be eligible. CMCA recommends that CARB establish a process for third parties such as registries, project developers and other parties to pre-qualify instruments/projects to be eligible to be purchased by CARB in the event the ceiling is triggered, and additional reductions are necessary.

Developers and private parties will respond to price signals from the market, but there will be a multi-year lag between those signals and the availability of reductions that meet the eligibility requirements set out in the legislation. Therefore, CARB should have this pre-qualification process set up and running by Jan 1, 2020 to provide developers enough time to be able to start developing projects if they are ever needed. Lastly, CARB should be required to issue a final ruling on instrument/project pre-qualification within 1 year (365 days) of a party submitting all the required documentation.

Without some form of prequalification process, it is not likely that private capital will invest in activities to provide these reductions prior to the need being triggered, which may significantly impede the ability of CARB to meet the requirements of the legislation in a timely manner.

For private capital to have confidence in being able to sell qualified instruments/projects to CARB when the price ceiling is triggered, some guaranteed percentage of the funds, say 50%, should be required to be dispersed through a Dutch Auction where any qualified project instrument/project that is offered in at a competitive price is guaranteed to be purchased.

CARB should be able to use other mechanisms or procurement options, such as RFPs and bilateral contracts to disperse the remainder of the funds as overseen by the Board with the intent of maximizing co-benefits to Californians. Any party should be able to sell qualified instruments/projects to CARB, including but not limited to compliance entities, project developers, speculators and NGOs.

In addition, as discussed above, CARB should explore one-way linkage agreements with other relevant jurisdictions so that this option is available if needed. The linkage agreement does not have to be a broad authority for California entities to procure instruments at market prices – it can be limited, if desired, to ARB being able to procure instruments only as part of the ceiling price mechanism.

CARB should, if possible under its authority, further explore methodologies of either pre-procuring or pre-contracting or otherwise incenting third parties to develop qualified reductions, if, for example, prices reach the second price containment point or some level closer to ceiling prices.

CARB should always seek to purchase 1 for 1 reductions at the lowest reasonable price and generate savings compared to the ceiling price, if at all possible. Recommendations on using such savings are discussed at the end of this section.

On timing, CARB should seek to acquire the required emission reductions as quickly as is practicable, without depleting the available supply of ARBOCs upon which compliance entities rely for normal use. CARB should obtain sufficient instruments to meet its one-to-one reduction obligation in a timely fashion, keeping in mind the impact of ARB purchases on the supply of ARBOCs in any given compliance period to ensure that compliance entities still can procure offsets in the market up to the maximum amount of offsets entities are allowed to submit towards their compliance obligation (4% of the total budget from 2021-2025 and 6% of the total budget from 2026-2030).

If ARB procurement would detrimentally affect that compliance threshold, then CARB should achieve the one to one reduction obligation over a greater period of time, but strive to procure the required emissions reductions over no more than three years.

Lastly, if ARB is able to purchase emission reductions at a lower cost than the ceiling price collected from compliance entities, CMCA recommends the following for the use of such funds:

1. First, ARB should seek where possible to spend the bulk (such as 60%) of such savings on strategies to help reduce emissions under the capped sectors in California. ARB may be able to achieve reductions that are not occurring due to

market inefficiencies or lack of investment capital, or help reduce the costs of reducing emissions in the capped sector so that those reductions happen more quickly. By targeting these capped sector reductions, hopefully ARB can help move emissions back below the level that resulted in compliance entities purchasing ceiling reductions. CMCA feels that in having met the minimum 1 for 1 reduction prior to using these funds to further reduce emissions that ARB has the authority to incent reductions in the capped sectors. As such, under all circumstances ARB should seek to uphold the principle of additionality and only act where absent its actions these emission reductions would not occur under business as usual.

2. Second, ARB should reserve a portion seek to spend (such as 40%) of such savings on developing future 1 for 1 reduction projects. This could include early stage investments in emission reducing projects or new technology development and could also take the form of deposits made with project developers that give CARB the right to buy future emission reductions at a pre-set and fixed price.
3. Finally, ARB should focus any remaining funds on achieving additional emission reductions (procuring additional offsets or compliance instruments from other jurisdictions) to offset observed or potential shortfalls in the expected reductions from non-capped sectors, such as from SLCP measures.

5. <u>OFFSETS & DIRECT ENVIRONMENTAL BENEFITS:</u>

Regarding the use of offset credits for compliance, a critical provision of the Cap and Trade program, AB 398 requires that a portion of the offsets surrendered for compliance are sourced from projects that provide direct environmental benefits in the state of California: *“direct environmental benefits in the state” are the reduction or avoidance of emissions of any* *air pollutant in the state or the reduction or avoidance of any pollutant that could have an adverse impact on waters of the state."*[3]

CMCA agrees with the ARB Staff structure proposed in the October 12th workshop, that for the compliance years during the period from January 1, 2021, to December 31, 2025, inclusive, an entity may meet up to 2 percent of a compliance obligation by surrendering offsets that do not provide direct environmental benefits in the state without any obligation to procure or surrender an equivalent number of offsets that do provide direct environmental benefits in the state. Similarly, for compliance years from January 1, 2026, to December 31, 2030, an entity may meet up to 3 percent of a compliance obligation in this manner.

CMCA recommends that offset projects whose address is physically located within the state of California should automatically earn designation as a project that delivers environmental benefits in the state, both for past and future ARBOC issuances.

When a project address is physically located outside of the state of California, CMCA recommends that CARB consider developing a short form that allows an Offset Project Operator ("OPO") or an Authorized Project Designee ("APD") to apply for designation as a project that provides direct environmental benefits in state. As it may not be immediately apparent how the project provides such benefits to California, the form would request a description of the rationale such that CARB can make a determination for all ARBOCs from that project, whether past or future issuances. Once determined affirmatively, CARB should designate qualifying ARBOCs as such. To support market awareness of the projects granted such designation, the determination can be made public by posting to CARB's website and the appropriate Offset Project Registry.

It may not immediately be apparent from a project's registration information that a project provides direct environmental benefits in the state. Furthermore, with the development of innovative projects and the anticipated adoption of new protocols, environmental benefits can be delivered to California in ways unforeseen today. CMCA further recommends that CARB

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[3] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180AB398 *[p11: s38562(c)(2)(E)(ii)]*

retain discretion to interpret and apply the legislative definition. As an example, ODS destruction projects are currently designated as occurring out-of-state, primarily in Arkansas, because no destruction facility is located in California. However, a significant portion of the high-GWP refrigerants destroyed are known to be collected in California. Emissions of these short-lived climate pollutants have certainly been avoided in-state along with other direct environmental benefits to California from reducing the end-of-life impacts of these chemicals. If a project developer can demonstrate to CARB's satisfaction that out-of-state destruction provides real, permanent, quantifiable, verifiable, enforceable and additional environmental benefits beyond the reduction in GHG emissions they satisfy the requirement for "direct environmental benefits in the state," as per the AB 398 definition. Other examples include forestry and agricultural projects located outside of the state but within California watersheds such as the Klamath River Basin watershed. This illustrates the need for project-specific review of any project claiming to deliver environmental benefits in California.

The assertion, evaluation, and decision regarding whether a project provides direct environmental benefits in California should be incorporated into the offsets issuance process in order to facilitate the development of projects that provide direct environmental benefits in the state, even when such projects may be physically located elsewhere.

CMCA recommends that the reduction of the 8 percent offsets usage limit and the further limitations on a portion of the limit for projects that provide direct environmental benefits in the state not be applied to offset policies in linked jurisdictions. For linkage determinations, SB 1018 (2012) explicitly refers to the criteria established under AB 32 as the measures of offset program stringency. Specifically, offsets are required to be real, permanent, quantifiable, verifiable, enforceable, and in exceedance of reductions that are otherwise required by law or regulation or that are expected to occur under business-as-usual. Nowhere did lawmakers indicate that the proportion of offsets is to be considered in linkage decisions. Indeed, offsets usage is only one of many components of a cap and trade program that should be evaluated when evaluating new potential linkage partners or harmonization with existing linkage partners.

6. BANKING & HOLDING LIMITS:

In establishing a regulation applicable from January 1, 2021, to December 31, 2030, AB-398 directs CARB to *"Establish allowance banking rules that discourage speculation, avoid financial windfalls, and consider the impact on complying entities and volatility in the market."*[4] CMCA recommends that CARB establish the same compliance rules that exist in the pre-2021 regulation:

> *"To fulfill a compliance obligation, a compliance instrument issued pursuant to sections 95820(a) and 95821(a) must be issued from an allowance budget year within or before the year for which an annual compliance obligation is calculated or the last year of a compliance period for which a full compliance period compliance obligation is calculated, unless: (A) The allowance was purchased from a California Allowance Price Containment Reserve sale, is any other California-issued non-vintage compliance instrument, or is an Allowance Price Containment Reserve Allowance or other non-vintage allowance issued by a program approved by ARB pursuant to section 95941 as specified in section 95821(a); (B) The allowance is used to satisfy an excess emissions obligation; or (C) The allowance is eligible for compliance use pursuant to sections 95856(h)(1)(D) and 95856(h)(2)(D)."[Cap and Trade Regulations p136: §95856(b)(2)]*[5]

Continuing these rules would permit the surrender of compliance instruments issued prior to 2021 for retirement in the post-2020 period.

Additionally, and specifically with regards to banking of compliance instruments, CMCA recommends that CARB establish rules that are the same as those in the pre-2021 regulation, in which compliance instruments do not expire and are only retired when they have been surrendered and the Executive Office has retired such instrument:

> *"Expiration of Compliance Instruments. A California compliance instrument does not expire and is not retired in the tracking system until: (1) It is surrendered by a covered*

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[4] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180AB398 *[p11: s38562(c)(2)(H)]*

[5] https://www.arb.ca.gov/cc/capandtrade/capandtrade/unofficial_ct_100217.pdf

entity or opt-in covered entity and retired by the Executive Officer; (2) An entity voluntarily submits the instrument to the Executive Officer for retirement; or (3) The instrument is retired by an approved external GHG emissions trading system to which the Cap-and-Trade Program is linked pursuant to sub article 12." [Cap and Trade Regulations p263: s95922(c)(1-3)][6]

CMCA recognizes the importance of banking in limiting potential impacts on complying entities from market volatility. Maintaining banking rules that preserve the value of early investments in compliance instruments and emission reduction projects can help mitigate price volatility.

Banking rules that are currently in place allow complying entities to manage price risk and the uncertainty that arises from varying production. For example, an electric power generator's compliance obligation varies with its output, which can be greatly influenced by factors outside of its control such as weather and local economic activity. These factors pose challenges to planning and meeting a compliance obligation, particularly where a mild summer can lead to decreased electric demand and possible over-hedging where the entity has purchased more instruments for a given year than are actually required. Having the flexibility to carry forward unused compliance instruments, when actual output is less than forecast, and also to purchase in the secondary market allowances that other market participants hold, when actual output is greater than forecast, mitigates the price volatility that might otherwise occur.

CMCA encourages CARB to continue the use of holding limits, which provide boundaries on the amount of speculation and potential financial windfall that might occur. CMCA notes that the added liquidity (increased numbers of buyers and seller in the market) enabled by the participation of non-compliance entities has the potential to absorb excess compliance instruments during periods of market oversupply and also to release such supply when the market is short, reducing the potential for extreme price spikes. CMCA also believes that the General Prohibitions on Trading[7], as in place in the current Cap and Trade regulation, have been well vetted in their development by CARB and proven effective for more than four (4) years in

[6] https://www.arb.ca.gov/cc/capandtrade/capandtrade/unofficial_ct_100217.pdf

[7] https://www.arb.ca.gov/cc/capandtrade/capandtrade/unofficial_ct_100217.pdf *[p259: s95921(f)]*

mitigating unjust financial windfalls and at this time does not see a need to change these rules. However, ARB should carefully monitor the situation in the future years of the program to make sure these findings are still accurate.

7. *ALLOWANCE LEVELS:*

The CMCA stakeholder group submitting these comments recognizes the requirement that AB 398 places on CARB to "*evaluate and address concerns related to overallocation in the state board's determination of the number of available allowances for years 2021 to 2030."*[8] The group also acknowledges that GHG emissions under the Cap-and-Trade Program are currently below capped levels, which could, due to the Program's banking rules, allow for covered GHG emissions to exceed capped levels in future years while still achieving the cumulative covered GHG emissions budget. The group will continue to review this issue as well as the GHG accounting issues noted in the final 2030 Scoping Plan Update, and expects to provide comments and possible recommendations on them in a future comment period.

CONCLUSION:

The decisions made by CARB on these future 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 these comments. CMCA also looks forward to continuing its involvement and working together with CARB throughout the stakeholder process.

[8] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180AB398 *[s38562(c)(2)(D)]*

Dated: January 10, 2017

By: ______________________

Andre Templeman

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Cc: Mary D. Nichols
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