Clerk of the Board
California Air Resources Board
1001 I Street, Sacramento, California 95814
Submitted to: http://www.arb.ca.gov/lispub/comm/bclist.php

2 August 2013

IETA COMMENTS ON CALIFORNIA AIR RESOURCES BOARD'S PROPOSED CAP-AND-TRADE AMENDMENTS

On behalf of the International Emissions Trading Association (IETA), I appreciate this opportunity to provide comments in response to the California Air Resources Board's (ARB) 18 July 2013 Public Workshop on Proposed Amendments to the California Cap-and-Trade Program and associated supporting documents outlining those amendments. We thank you for considering IETA's perspectives on the matter.

ABOUT IETA

IETA is dedicated to the establishment of market-based trading systems for greenhouse gas emissions that are demonstrably fair, open, efficient, accountable, and consistent across national boundaries. IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our 140 member companies include some of North America's, and the world's, largest industrial and financial corporations—including global leaders in oil & gas, mining, power, cement, aluminum, chemical, pulp & paper, and investment banking. IETA also represents a broad range of global leaders from the industries of: data verification and certification; brokering and trading; offset project development; legal and advisory services.

OVERVIEW

IETA's comments are structured around five topics:

1. **Compliance Unit Surrender Order;**
2. **Transaction Reporting Requirements;**
3. **Cost Containment;**
4. **Holding Limits; and**
5. **Ownership of Facility.**

1. COMPLIANCE UNIT SURRENDER ORDER

IETA's membership has a strong preference for individual entities to be given the flexibility to indicate which compliance units they would like to surrender. We appreciate the need to provide a default surrender order in case an entity fails to indicate its own surrender order, but this default order should not supersede an entity's preference, if indicated. We understand that the Compliance Instrument Tracking System Service (CITSS) currently does not have the functionality to allow entities to indicate their own retirement order preference, but our membership contends that the benefits of implementing such functionality outweigh the cost.

Holding Limits:

Due to the holding limit as currently written, a large final emitter (LFE) has comparatively less flexibility to keep allowances in its holding account than other regulated entities, and often must store a significant number of allowances in its compliance account. Where smaller entities may hold onto allowances in their holding account right up until the compliance deadline, an LFE must keep allowances to cover its compliance obligation in its compliance account to navigate the holding limit. The pre-determined compliance unit retirement order that ARB proposes presents just another additional challenge to navigate for account representatives, who will face the additional challenge of balancing allowances and offsets in their compliance accounts.

Tax and Accounting Considerations:

ARB officials may wish to consider the EPA's Acid Rain Program in determining the importance of an entity's ability to choose which compliance units it retires in light of tax implications. In the Acid Rain Program, an entity has the option of placing into a compliance account those allowances that it decides it wants EPA to retire for that year. Embedded in the selection of allowances for retirement is the ability to choose to retire specific allowances based on their tax basis (this is often referred to as "specific identification" by the accountants).

In the Acid Rain Program, for tax purposes the basis of a freely allocated allowance is zero. That contrasts with a purchased allowance, where for tax purposes the basis would be the purchase price. Because either type of allowance is fully fungible, an entity could then choose to retire an allowance based on its tax basis. Since SO2 allowances are treated as a capital asset, using specific identification, a company could choose allowances based on how it would impact its capital gains posture for a given year.

Has ARB considered whether there might be a tax consequence if ARB uses a default compliance surrender order that prevents entities from indicating which specific units they want to retire? An overarching problem here may be that without access to *serial numbers*, an entity would not be able to indicate which type of allowance it wants to retire for tax reasons anyway.

A second consideration concerns the different inventory accounting methodologies that entities in the California market can choose to use. An entity could choose to use LIFO (last-in, first-out), FIFO (first-in, first-out), specific identification, or average cost for its methodology of book accounting. Importantly, if an entity uses LIFO, FIFO or specific identification for book accounting purposes, then it *must* have the ability to tell ARB which allowances to retire consistent with its chosen inventory accounting methodology.

Defining a Default Backstop Surrender Order and the Eight Percent Offset Limit

IETA appreciates that ARB wants to avoid a situation where an entity fails to indicate its own compliance unit surrender order and is left in a position where it fails to meet its compliance obligation. To address this, a default compliance unit surrender order could be established along the lines of ARB's current proposal, which would only apply should an entity fail to indicate its preferred order.

IETA recommends that in this default compliance unit surrender order, if an entity over-surrenders offsets in its annual compliance years to the extent that it is already beyond its 8% limit by the triennial compliance deadline, ARB devise means to allow those over-surrendered offset credits to retain value – whether that be through returning the units to the compliance entity, allowing those excess units to be applied towards the next compliance period, or some other means.

2. TRANSACTION REPORTING REQUIREMENTS

ARB's rationale for proposing more detailed transaction reporting requirements, based on three different transaction types, is that doing so would provide ARB with more useful transaction data that could inform the marketplace.

IETA appreciates that ARB has listened to stakeholder feedback that the current one-size-fits-all approach to transaction reporting is not ideal, considering the different types of transactions that can occur. However, there are some further questions and concerns that IETA would like to point out.

Generally, concern has been voiced amongst our membership that ARB may be wading into CFTC's jurisdiction in requiring that entities report on futures trades – particularly those falling under the third category of ARB's proposed list: "Exchange-Traded Contracts". Since CFTC already regulates these types of transactions, it seems redundant – and overly burdensome – that entities be required to report these transactions to ARB too.

More specifically, there is some confusion and inconsistency in the way that ARB refers to secondary and/or spot market transactions. A few examples follow:

- On page 23 of ARB's Discussion Draft of proposed amendments, the definition of "Futures" seems to be an incomplete version of the CFTC definition of futures.[1] It may be helpful to utilize the full CFTC definition.
- On page 49 of ARB's Discussion Draft of proposed amendments, the definition of "Spot" is a contract for the immediate delivery of and payment for a product. Yet in the breakdown of the three different transaction types on page 213 (§95921(b)(2)), it appears that trades for delivery *within* 3 days could be considered spot, which might contradict ARB's definition of spot as "immediate delivery". Added clarity would be appreciated.
- Further to the previous point: it's possible that "futures" can be traded up to 3 days before delivery. Therefore, should such a trade be considered "spot" or "futures"? This confusion between "futures" and "spot" definitions makes the reporting requirement unclear on page 215 (§95921(b)(5)(C)), which requests that entities "identify the contract as spot or futures".
- The proposed reporting requirements attempt to standardize the reporting. That may be appropriate in certain cases. However, "over the counter" transactions do not generally lend themselves to standardized reporting, and may thus prove onerous for reporting, and complicated for enforcement.
- The definition of "over-the-counter" turns on whether the subject matter of the trade is listed on an exchange, not whether the trade takes place through an exchange. Since the

[1] See CFTC definition of "Futures" here: http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_f#futurescontract

third category relates to agreements for sale of compliance instruments through any contract arranged through an exchange or Board of Trade, the definition seems deficient.

Counterparty Account Representative Confirmation

Section 95921 (b)(1)(B) (page 213) of the discussion draft proposes that the seller of units in a transaction must need to know the "… *identification of a primary account representative or alternative account representative for the destination account confirming the transfer request, if confirmation of the transfer request is required*."

IETA members with significant experience being involved in deliveries of cleared futures maintain that requiring such an additional test for a transfer will add unneeded complication. Specifically PARs and AARs at firms regularly change and it would not be common for counterparties to keep each other abreast of these personnel changes.

Should such a provision be implemented, how quickly would CITSS be updated for personnel changes submitted by the buying party? Further, depending on how the test is implemented (e.g. drop down name selection vs. free form) and whether spelling of the names need to match exactly, transfer initiations may never get out of the gate due to spelling errors. Finally, since all transfer of allowances that originate from trading must be confirmed by the buying PAR or AAR, what is the added value of having the seller input those names to initiate the transfer? Added clarification on these questions would be appreciated.

3. COST CONTAINMENT

As an initial first step, IETA supports ARB's proposal to make available 10% of future allowance budgets, as needed, at reserve sales once per year starting in 2015 at the highest price tier of the Allowance Price Containment Reserve (APCR).

This provision may provide some short-term relief in the case that prices rise unexpectedly. However, IETA does not believe that this provision adequately satisfies the Board Directive to prevent allowance prices from rising beyond the APCR, particularly in the case of an extended period of high demand due to unforeseen market dynamics or economic imbalances. Ultimately, it is in ARB and IETA's interest alike to ensure that prices do not rise so high that the Governor feels pressure to step in and exercise his/her right to suspend the cap-and-trade program.

IETA encourages ARB to re-visit the proposals originally discussed at the 25 June 2013 Public Workshop (including those by ARB, EMAC, and the Joint Utilities Group[2]), which explored a number of innovative options that would serve to keep prices below the highest-tier APCR price, while at the same time maintain environmental integrity.

We appreciate that some of these options would take much more work to determine how they could be implemented, both technically and legally. The timeframe with which ARB had to work with for this rule-making session may not be adequate to fully explore all the possibilities.

[2] Joint Utilities Group Presentation: http://www.arb.ca.gov/cc/capandtrade/meetings/062513/industry-present.pdf

However, IETA would be pleased to work with ARB to continue to explore the plausibility of going beyond this first proposed option to address cost containment.

In particular, IETA considers two options presented at the 25 June 2013 workshop to be worth further consideration:

Offsets

Expanding offset supply would be an effective means of containing the cost of the cap-and-trade program, while also ensuring environmental integrity of the program.

Additional low-cost compliance options could be introduced into the system through offsets in a variety of ways, but two relatively simple options to implement would be: 1) expand entity compliance quotas beyond 8%; or 2) allow entities to carry over unused offset quotas from one compliance period to the next.

These are options that could be applied immediately or else triggered at certain pre-determined allowance price points, without impacting the program's environmental integrity. It would be important to consider that offset quotas not be increased so much that allowance prices drop below the point in which they would encourage additional offset projects and low-carbon investment.

Sourcing Allowances from Third Party Greenhouse Gas Reduction Programs

If faced with an extreme case where keeping prices below the highest tier of the APCR was proving difficult, ARB could have a provision ready to kick in that allowed the creation of additional allowances to be sold at the highest tier price, providing crucial cost relief.

In order to maintain environmental integrity, the state of California could use the revenue from the sale of these additional allowances to buy and then retire quantifiable and certified allowances from third party greenhouse gas reduction programs (such as the Regional Greenhouse Gas Initiative (RGGI)). Meaning that for each additional California Carbon Allowance (CCA) that ARB created and sold, a corresponding RGGI allowance would be retired. California could even choose to implement a quota system whereby for each additional CCA it created it would retire (for example) three RGGI allowances.

Not only would such a system provide cost relief and maintain environmental integrity, it would also serve to indirectly link its market to other markets – a goal outlined in AB 32 in building regional and international markets.

Admittedly, developing such a provision would require much more research into various technical and legal procedures, but IETA encourages ARB to continue to explore the possibility of doing so. IETA would be pleased to work with ARB moving forward in this pursuit.

4. HOLDING LIMITS

IETA supports changing the requirements for the limited exemption, enabling allowances corresponding to the limited exemption to be placed in the compliance entities holding account, not requiring those allowances to be placed in the compliance account (as is recommended in the proposal from the Joint Utilities Group).

5. OWNERSHIP OF FACILITY

Section 95820(i) entitled "Change of ownership" includes provisions relating to "entities being purchased". It appears that there may be confusion over the effect of the purchase of a corporation's shares or the equity of other entities which own facilities. In the case of the acquisition of corporate shares (and often in the case of the acquisition of equity of other entities), this does not necessarily result in a change of ownership of the facility.

CONCLUDING REMARKS

IETA appreciates the opportunity to share our comments related to ARB's 18 July 2013 Public Workshop on Proposed Amendments to the California Cap-and-Trade Program and associated supporting documents outlining those amendments. We look forward to continuing our engagement on these topics, and others, over the coming months and during the official 45 day comment period expected to begin on 4 September 2013 once the proposed amendments are officially released. Not only is IETA intent on helping to support a fully-functional California carbon market, we are also committed to helping achieve the goals of AB 32 to develop inter-jurisdictional and regional linked markets in order to realize environmental goals in an economically efficient manner.

If you have any questions, or further clarification is required, please do not hesitate to contact Robin Fraser (fraser@ieta.org) or Katie Sullivan (sullivan@ieta.org).

Sincerely,

Dirk Forrister
President and CEO