13 July 2010

Kevin M. Kennedy, Ph.D.
Assistant Executive Officer
Office of Climate Change
California Air Resources Board (CARB)

IETA COMMENTS ON COST-CONTAINMENT DESIGN OPTIONS UNDER CONSIDERATION

Dear Mr. Kennedy:

On behalf of the International Emissions Trading Association (IETA), I am grateful for this opportunity to provide comments on California's cap and trade Preliminary Draft Regulations (PDR) and, specifically, the recently-discussed cost-containment measures under consideration by the California Air Resource Board (CARB). The PDR includes many provisions that will help to drive a greenhouse gas market capable of maximizing both environmental and economic benefits. We hope that CARB considers IETA's perspective and insight as you move forward with draft cap and trade regulations.

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 170 member companies include some of North America's, and the world's, largest industrial and financial corporations—including global leaders in oil, electricity, cement, aluminum, chemicals, paper, and banking; as well as leading firms in the data verification and certification, brokering and trading, offset project development, legal, and consulting industries.

First and foremost, IETA extends its appreciation for CARB's leadership in developing a greenhouse gas cap and trade program, and we applaud California regulators for their ongoing efforts to thoughtfully integrate practical and effective reduction mechanisms that minimize compliance costs while promoting transparency. Although IETA strongly believes that a national cap and trade program is the best means of reducing greenhouse gas emissions in a cost-effective manner, IETA commends CARB for its leadership in developing a framework that will encourage and provide useful lessons in the development of a federal or continental program. California's program promises to create an effective pricing mechanism for carbon, by enabling the private sector to invest resources in the most efficient and effective manner, thereby minimizing overall social costs. Moreover, through appropriate market design and roll-out, California's cap and trade program should lead to clean energy job creation while transitioning the region to a competitive, low-carbon economy.

According to the discussion at its June 22 workshop, CARB continues to consider a range of cost-containment options for incorporation into its state-wide cap and trade program. Options currently under consideration by CARB fall into three main categories of mechanisms, all with a view to increasing the supply of instruments into the market: 1) relaxing the quantitative use limit for offsets; 2) allowing limited use of future vintages; and 3) releasing allowances from a reserve.

As CARB continues to explore these cost-containment options, IETA offers some key observations and recommendations for consideration.

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1. OFFSET MARKET DEVELOPMENT & QUANTIFICATION LIMITS

Draft measure under consideration: CARB is considering relaxing the currently proposed limit of offsets from 4.0% of total compliance obligation to 8.0%, once a certain period is reached.

IETA welcomes CARB's decision to reconsider its original proposal to limit use of offsets to 4.0% of the total compliance obligation to potentially allow a higher percentage of offsets use under the final design framework. IETA believes that the use of high-quality offsets should not be constrained, and the currently proposed offset limit is sub-optimal for achieving California's overall environmental and economic objectives.

However, if a program *must* include offset limits, IETA believes that it should be designed to ensure that the opportunity to create offsets is effectively maximized through an appropriately designed framework. The framework should take the form of a bottom-up, criteria-based approach that allows offsets from any sectors/projects that successfully meet CARB's additionality criteria, to provide incentives for as many high-quality, low-cost emission reductions as possible. This framework should also allow for offset projects to come from any jurisdiction outside of California that meets CARB's requirements. Utilizing the greatest possible geographic scope for issuance without compromising administrative efficiency or duplicating efforts already established or underway in other jurisdictions will help to ensure that reductions are met at least-cost to society.

IETA offers the following observations and recommendations with respect to offsets usage:

- Principles in evaluating offset limitation options: IETA supports California's objectives for evaluating cost-containment mechanisms: Supporting a robust, transparent, liquid market that ensures environmental integrity and market efficiency. As a result, directly prohibiting the use of offsets in the regulated market would work to eliminate a major cost containment mechanism. By providing low-cost emission reductions that are available in the near-term and act as a bridge towards long-term deep reductions, offsets provide critical assistance containing costs and stabilizing prices while giving covered entities the flexibility they need to efficiently reduce emissions.

- Eliminating the quantitative usage limit: As currently written, the PDR would place a cap on the percentage of offsets available to individual covered entities. While we are encouraged that CARB is considering increasing this limit, IETA continues to support the removal of a quantitative usage limit prohibiting covered entities from meeting more than a percentage (particularly a low percentage) of their compliance obligations through offsets. Since the PDR already ensures that only real, permanent, and verifiable offset credits are allowed into the market, arbitrary usage limits will only prevent further reductions of greenhouse gas emissions in a cost-effective manner. Furthermore, program and entity-usage limits would create uncertainty for offset project developers and investors with long-term planning horizons. Economic analyses by the US EPA, and others, have shown that incenting a robust market in offset reductions (i.e., emissions reductions from diverse sources outside a mandatory cap) can dramatically reduce the overall cost to taxpayers and consumers when meeting the goals of global warming legislation. In the case of federal program analyses, without offsets the cost of compliance could be over two and half times higher than with unrestricted use of offsets.[1] Accordingly, offsets provide critical cost-containment and price stability by providing flexibility to covered industries to find the lowest available cost emissions reductions across a range of options.

[1] Source: U.S. EPA, Analysis of the Climate Stewardship and Innovation Act of 2007 (McCain-Lieberman, S. 280) (July 16, 2007); U.S. EPA, Analysis of the Low Carbon Economy Act of 2007 (Bingaman-Specter, S. 1766) (Jan. 15, 2008).

- Providing a broad "positive list" of eligible offset project types based on existing protocols, as well as a clear process for introducing new project types: We stress that draft regulations should initially include a "positive list" of offset project types having well-understood and accepted methodologies. Such a list will provide clarity to project developers that qualifying projects of certain types would be considered, and would also ease administrative burdens for project managers, particularly when dealing with common and well-understood project types. Without such a list, the efficacy of the carbon offset market as a compliance tool will be minimized during the period where the appropriate governing agency promulgates additional regulations. In turn, this limits the ability of offsets to act as a cost-mitigation tool in the first few years of the program. The process of introducing new project types should be criteria based and entirely non-restrictive.

2. USE OF FUTURE VINTAGE ALLOWANCES

Draft measure under consideration: CARB is considering the option of allowing regulated entities to borrow future emission allowances to comply with compliance obligations.

Both banking and borrowing are important design elements in the architecture of an effective and efficient cap and trade program. IETA therefore welcomes CARB's decision to consider allowing entities to "borrow" vintage allowances from future compliance periods to be used to satisfy obligations under current compliance periods.

IETA offers the following recommendation regarding the use of future vintage allowances:

- Interest-Free Borrowing as a Key Cost-Containment Measure: IETA believes that borrowing serves as an important means of controlling costs, particularly in the early years of California's program when the offsets program may not be robust. IETA recommends allowing an unlimited amount of interest-free borrowing from allocations within compliance cycles. Unlimited banking across compliance periods provides an important means of controlling cost and increasing flexibility that will assist companies not only in long term planning, but also in adjusting to unanticipated events.

3. RESERVE PRICE & HOLDING ACCOUNT

Draft measure under consideration: CARB has proposed establishing a "soft collar" in association with a minimum auction price (reserve price) for allowances, with unsold allowances being held in a "special reserve holding account". This account would make reserve allowances available for direct purchase by entities at a specified "window," such as when demand for the permits exceeds supply.

IETA generally cautions the formation of an allowance reserve in program design. An allowance reserve, at best, can perform a price smoothing function and reduce market risk, provided the mechanism's parameters, size, and conditions under which reserves will be released into the market are defined and certain. Under this best-case scenario, the market will effectively factor reserve dynamics and impacts into pricing.

In contrast, if reserve parameters and conditions are not clear to market participants, the existence and impact of the allowance reserve essentially becomes a "wild card", whereby unnecessary risk is injected into the market, debilitating the emergence of a fully functional market and impeding policy objectives.

Furthermore, to the extent that 100% auctioning of allowances is *not* part of the program's design, all allowances up for auction are likely to be sold, trivializing the need for an allowance reserve system. Since any discussion of an allowance reserve is tied to other important program parameters, CARB should determine the need for such a mechanism in consideration of overall program design.

IETA offers the following observations and recommendations, below.

- Avoid the return of unused offset compliance allocations back to the general pool. With the demand and supply of allowances being inelastic, cost containment – particularly over the first compliance period – is of significant concern to market players. IETA advocates a position that treats the percentage compliance allocation to each individual emitter as an individual tradable property right. That said, unused compliances should not be aggregated across the entire state for redistribution, but rather retained by an individual emitter for use over the next compliance period. IETA encourages CARB to consider one of the following options: avoid the case in which entities possess unused offset rights by ensuring that each entity has a net shortage of allowance allocations; or convert unused offset entitlements to an absolute amount at the end of each compliance period, then add this amount to the next compliance period. In designing the state program, we must look to the successes and failures emerging from other schemes. For instance, in terms of the former option, regulators in the EU Emissions Trading Scheme (EU ETS) did not ensure that each emitter held a net shortage of allowances, which led to market implications and complications

- If federal rules are deemed insufficient by California authorities, IETA recommends that broad and coordinated regional accountability limits be applied, with holdings limits used as a last resort. IETA believes "holdings limits" are difficult to effectively enforce and can actually impede the proper functioning of a cap-and-trade program, particularly in the early years of the program. Functioning carbon markets have both buyers and sellers that have differing appetites and views of market fundamentals. These markets vest market participants with the discretion to decide how much or little to buy of a particular commodity. Limiting market participation through holdings limits unnecessarily increases overall compliance costs and limits the market's ability to produce a forward price signal, and could further expose firms to detrimental regulatory and commercial risk. Moreover, position limits could unnaturally limit the ability of market participants to close the "speculative gap" between advanced hedging demand for future allowances and the subsequent spot sales of allowances. We note that the EU carbon market, as well as the US SO2 and NOx, markets have operated successfully for many years without position limits.

  In considering safeguards to protect against market abuse like collusion, one alternative policy prescription to holdings limits would be the use of "accountability limits," in which the regulator would set levels above which market participants would attract greater regulatory scrutiny and potential imposition of holdings limits at a future stage. At the inception of the carbon market, this type of approach seems more appropriate than setting strict holdings limits from the outset. This approach would enable the regulator to conduct market surveillance to determine whether there are signs of potential abuse rather than imposing limits at the outset that could limit market development. Considering how holdings limits may hamper the market's ability to function most effectively, we ask if this incremental cost is justified, and what in fact the additional cost would be.

- IETA recommends that any accountability limits or holdings limits should only apply initially to allowance holdings as a way of encouraging development of offsets supplies. California is considering potential limits on the use of offsets as a method of encouraging internal abatement by covered entities, as discussed above. Given the wide range of possible offsets supplies and the limits on offsets usage, it is unlikely that an entity could gain such a commanding presence in the offsets market that it could manipulate prices. This is particularly true in a market that will trade predominantly in allowances.

Unlike allowances, of which quantities are finite, developers can always create more offset credits. Furthermore, the overall market design has other built-in safeguards against manipulation by offsets sellers. If an offsets seller attempts to manipulate prices, covered entities can utilize banking, borrowing (within a three year compliance period), internal abatement, and potentially other recognized allowance markets. These flexibilities not only lower costs for covered entities, but they also protect against market abuse by offsets sellers. Additionally, given the regulatory and technical risks in developing offsets projects, application holdings limits would create a regulatory risk for offsets projects that could discourage supply formation. This would, in turn, work against the cost-containment goals of the California's offsets policy. In the end, responsible public policy should encourage companies to scour various projects in various regions (sub-national, national, and international) for real and credible low-cost reduction opportunities. Those who take the risk of developing such projects should reap rewards at the market price. If California intends to limit the overall amount of offsets allowed in the system, it should not add an additional layer of "holdings limits" that could lead to market distortion, impeding market growth and price discovery.

4. LINKING

Based on evidence and experience, linking regional and worldwide emissions trading markets would provide greater market liquidity while encouraging the realization of the most cost-effective reduction opportunities for greenhouse gas emissions. Allowances purchased in trading markets from outside of California should be accepted, provided these units emerge from jurisdictions that have comparable degrees of administrative and environmental integrity. As a result, the evaluation of programs from which to accept allowances should be focused on program quality, rather than the steepness of the rate of emissions reductions.

IETA offers the following additional recommendations regarding linkages, below.

- Regional and International Linking: As the supply of offsets created by CARB-approved protocols is not expected to meet forecasted program demand, in addition to expanding offset limits and criteria, state officials must consider how to practically link with external offset and allowance programs, including the Western Climate Initiative (WCI), Clean Development Mechanism (CDM), and EU ETS. In addition, IETA strongly supports CARB's consideration of Reduced Emissions from Deforestation & Degradation (REDD) credits into its state program.

- Recognizing Certified Emission Reductions (CERs) approved under the CDM: As currently written, California's PDR would first require a separate Memorandum of Understanding (MOU) between that state and non-Annex 1 countries in which CERs are generated. As these international offsets are already issued under strict and internationally-recognized frameworks and criteria, IETA considers this requirement redundant and administratively inefficient. CARB should directly accept CERs, without imposing additional requirements that may slow the process and mitigate the sound development of California's market.

CONCLUDING REMARKS

In summary, IETA believes that, among the cost-containment measures being considered by CARB, those with the greatest potential for emission reductions and administrative efficiency include: expanding the compliance limit on offsets; establishing broad offset criteria to include as many sectors as possible; and allowing limited borrowing of allowance to complement unlimited banking. In addition, IETA strongly recommends that California consider linkages with comparable trading systems as an additional cost-containment measure. IETA emphasizes that these measures are mutually inclusive.

Once again, on behalf of IETA and our 170 member companies, I would like to thank you for your attention to these comments. Please do not hesitate to contact either myself or Katie Sullivan (sullivan@ieta.org) with questions.

Sincerely,

Henry Derwent
President and CEO