

January 9, 2010

Kevin Kennedy, Assistant Executive Officer
California Air Resources Board
1001 I Street, 6th Floor
Sacramento, CA 95814

Comments Cap & Trade Preliminary Draft Regulation

Dear Mr. Kennedy:

This letter provides comments on the November 24, 2009 draft regulation titled “Preliminary Draft Regulation for a California Cap-and-Trade Program.”

These comments are offered by CantorCO₂e, LP on behalf itself and clients that are subject to the requirements of the California Global Warming Solutions Act (AB 32). These clients own sources that have operated in California for periods of time ranging from over one hundred years to those that are both contemplating establishing operations in the state. Others have technologies that promise to reduce greenhouse gas emissions in new and cost effective ways. These clients are all joined by one common objective – that California adopt a program that focuses on achieving cost effective, certain, and expeditious greenhouse gas reductions in a fashion that is consistent with the requirements of AB 32.

CantorCO₂e is the world’s oldest emissions trading brokerage firm. Established in 1992 by Cantor Fitzgerald, we have played key roles in the development, implementation, and refinement of nearly every important emissions trading program in the world. Over the course of the last 25+ years those on our staff have served, chaired, testified before, been appointed to, and/or have been members of entities that opine on emissions trading related activities, including the **California Climate Change Advisory Committee** (appointed by the California Energy Commission), the **RECLAIM Three Year Audit Committee** (appointed by the South Coast Air Quality Management District), the **Massachusetts Governor**, the **Florida Governor**, the **President of the United States**, the **US Congress**, the **European Trading and Market Liquidity Group**, the **Emissions Trading Group** (a think-tank that was instrumental in shaping the European Emissions trading), the **Voluntary Carbon Standard** (an international body drawn up under the Climate Group), the **Environmental Markets Association**, and the **International Emissions Trading Association**.

Based on this experience we offer the following comments regarding the draft regulations:

1. § 95970 suggests that only 4% of a source’s compliance obligation can be satisfied with offsets. This restriction, combined with the expected use of auctions as a means to distribute the allowances, will serve to:
 - Needlessly drive up the cost of compliance for regulated companies with little or negative benefit for California’s climate.

- Potentially create significant greenhouse gas “leakage” by driving companies, jobs, and emissions out of California to states or countries where the cost of compliance is lower.
- Create significant and inefficient cost barriers to achieving emission reductions when other more proven and cost effective mechanisms are available.
- Marginalize (and render of limited consequence) the use of offsets.
- Reduce the supply of (and, perhaps, demand for) offsets.
- Discourage out-of-program sources that would otherwise NOT be subject to CARB control (for it is only such sources that can create credits) from taking steps that would have otherwise be taken to reduce emissions.
- Increase the likelihood that offset projects commenced in anticipation of a more robust demand for offsets may be reversed in the absence of such demand.

In the end, when faced with these restrictions:

- Regulated companies may choose to reduce production, shutdown, relocate, or expand operations in other states and countries that have more cost-effective cap and trade programs and/or that are not burdened with such restrictions.
- Offset creators may choose to expend their capital in markets that allow for the greater use of offsets.

Surely AB 32’s *broad* policy objectives will not be met if in-state emissions decline in large part because California sources elect to leave the state when faced with compliance costs that are inflated owing (in part) to an artificially restricted supply of offsets.

We recommend that CARB remove the quantitative restriction on offsets and develop a more cost-effective allowance allocation system. Limits should be based solely on the quality of credits (i.e., those credits which meet CARB defined criteria that ensure that credits are real, permanent, surplus, and enforceable). Any credits which meet CARB’s qualitative criteria should be allowed to be used by sources needing to demonstrate compliance with the law.

2. § 96040 suggests that price collars be used in a manner that keeps credit costs at levels that are neither too high nor too low. These sort of “Goldilocks controls” are of concern. Their existence allows well meaning civil servants and politicians, each with different agendas, to interfere with the market’s natural tendency to reach an equilibrium price. We believe that:

- A central goal of AB 32 is to extract reductions in the most certain, timely, and cost effective fashion.
- Nowhere in the law is a stated objective to inflict economic damage on covered sources.
- AB 32 affirm does not include a goal of generating revenue to fill state coffers.
- There is no carbon price that is too low....so long as the reductions required under the cap are achieved in a timely fashion.

- Prices should be able to rise and fall as low as supply and demand dictates.
- Low prices are a demonstration that the market is working...not that there is a problem.
- The strength and integrity of a successfully designed declining cap should dictate the proper price of carbon.

We recommend that:

- The market be insulated from Goldilocks-type price collars.
 - Flow controls, similar to those once used in EPA NOx cap and trade program, be used to adjust the carry over of banked credits from one compliance period to the next.
 - Enhanced banking and borrowing be allowed in the event that prices exceed a defined threshold.
3. § 96080 suggests that limits be imposed on the quantity of allowances that a facility may purchase or hold. Such limits suggest that CARB has an ability to judge both the intentions and prudence of how facilities manage their accounts.

We recommend that such restrictions not be imposed. As CARB cannot know the allowance requirements of a program participant -- and will not be accountable in the event that CARB imposed restrictions leave the facility with an imprudent quantity of allowances -- such restrictions are not advisable. For the same reasons, the regulations should not impose, market holding limits nor restrict the amount of compliance instruments a facility can obtain based on reported emissions.

We also recommend that reporting generally be limited to that which is necessary to track and account for the allowances and offsets that are transacted (i.e., buyer, seller, vintage, method of creation, price). While sources may elect to use a commercial clearing mechanism such a requirement should not be imposed on all transactions. Credits resulting from unique offset projects with unique parameters and risks are common and not suitable to standardization.

4. § 96240 disqualifies otherwise high quality emission reductions if the project activity commenced prior to January 1, 2007; this will:
- Penalize early actors.
 - Disqualify otherwise high quality credits that meet all other standards established in AB 32.
 - Reduce the volume of high quality credits available to the market.
 - Incrementally increase the cost of credits.
 - Potentially lead to an offset reversal (if project proponents are deprived of a means to recover their investment [i.e., by selling their credits] they may elect to abandon the offset creation project)

We recommend that CARB impose restrictions based on the quality of the credits, not on the date that the credits are created. Certainly, credits that are recognized through the Climate Action Reserve should be eligible for use as offsets, regardless of the date that the project commenced.

5. § 96260(a)(3) notes that offset credits must come from a geographical area deemed acceptable by CARB.

Since climate change is a problem with global dimensions and solutions we recommend that geography, in and of itself, NOT be used as a determining factor as to credit eligibility. Those credits which meet CARB's qualitative criteria (e.g., real, permanent, surplus, quantifiable, enforceable), regardless of their point of origination, should be allowed to be used as offsets.

6. § 96390 suggests that the liability associated with the maintenance of the credits be retained by the buyer of the credits. The PDR innocently suggests that high quality credits will naturally rise to the surface and the interests of the program (and the market) will be protected by a combination of high quality verifiers and sales contracts that apportion liability and provide guarantees.

Experience gained through nearly three decades of emissions trading and our participation in dozens of environmental markets suggests that neither well meaning verifiers nor cleverly written conveyance contracts will always be sufficient to protect the interests of the buyer or the market. While a "buyer beware" approach may have some application, it:

- Is not consistent with historical practice in emission markets.
- Is not practical, especially in situations where a credit may be created and then sold a number of times before it is used and applied.
- Raises transaction costs as prudent credit buyers will need to re-verify the credits, audit the prior evaluations of the initial verifier, and look into their crystal ball to try to determine if the CARB or some third party will (perhaps several years after their creation) challenge the credits after they are purchased and applied to a project.
- Would create two classes of separate and unequal credits:
 - allowances issued by (and enjoying the full faith of) the government; and
 - offset credits created by third parties (which could always be undermined by the some future legal challenge).

Further, CARB should not rely solely upon the use of high quality credit verifiers to ensure that credits are maintained because verifiers:

- Are not officers of the government and do not have the ability to stand in CARB's shoes when it comes to determining if CARB will (in a post credit creation and use conducted audit) determine that the credit creating activity meets the requirements of the rules.
- Will, given the potential lawsuits which may ensue after the credits are

transferred/used, find it very challenging to secure professional liability insurance.

- Will be unable to charge a fee that adequately compensates them for the cost of doing the initial and ongoing assessments, paying for liability insurance, and setting aside cash reserves in the event that any credits which have been reviewed by the verifier are subsequently determined to be bad.

We recommend that CARB should:

- Accept that offset reversals cannot (and should not), in all cases, be dealt with through contract nor by relying upon high quality verifiers.
 - As a rule, hold the project originator fully accountable for maintaining the credit in the event that, at the time that CARB determines the credits are no longer valid, CARB has a means to enforce against the project originator.
 - Only hold the credit user responsible where such user has contractually accepted such liability.
 - Recognize that some credits result from the use of protocols that effectively guarantee the positive environmental attributes of the credits in the event the project is reversed. Such credits include those that result from Climate Action Reserve protocols that shave off, set aside, and keep in the inventory, a portion of registered CRTs. This “shave and set aside” creates an insurance pool that can be used to give both credit buyers and CARB confidence that project reversals involving insured CRTs can occur without jeopardizing the environment.
 - Anticipate a time when the integrity of credits may be guaranteed through the bundling of credits with third party provided (and CARB approved) insurance.
 - Consider setting up an insurance pool where a small part of allowances and/or offsets are shaved off, set aside, and maintained in the inventory. Such set asides would serve to guarantee credits that result from projects that are reversed (in whole or part) after the credits are initially sold.
 - Stand behind determinations when they decide which credits are allowed into the program. Those credits which CARB concludes will not meet their criteria (e.g., perhaps because CARB cannot be sure that the credit will be maintained) and are not backed by CARB approved insurance should not be allowed to be used as offsets,
7. Subarticle 10 suggests that sources – existing and new -- may (depending upon CARB’s anticipated acceptance of recommendations proffered to CARB by academicians and others) be required to purchase a majority of their emission allowances through an auction. We believe that doing so will unnecessarily increase the cost of the program, prompt facilities to move out of state, render sources less able to develop and implement controls, and contribute to massive emissions leakage.

A better strategy is to utilize a simple allocation system. Under such a system, sources that are in operation at the commencement of the program are provided an allocation that allows them continue to operate. New sources are either given a special allocation (which may be set aside from the initial allocation) or allowed to buy surplus allowances from existing sellers.

The logic supporting the use of free allocations (as opposed to 100% auctions) is stated below:

- Historically, successful emissions trading programs have relied upon allowance distribution systems where a source is offered a declining emission checkbook without cost to the source for the initial allocation.
- While the RGGI market relies upon an auction mechanism to distribute allowances we have seen one RGGI state divert revenues raised the auction to fund non-GHG related activities. We understand that other states, faced with troublesome deficits, are also considering diverting RGGI raised monies to be used to pay for non-climate change related programs/costs.
- The free distribution allocation method puts tons into circulation and rewards sources that discover they can benefit economically by reducing their allowance needs and selling their surplus. In contrast, an auction is another form of a carbon tax, one that delivers revenues to the government without the obligation to make prudent decisions regarding the use of such monies and allows deep pocket sources to continue to emit GHGs so long as they pay the tax.
- An allocation system (similar to the federal SO₂ acid rain program) gives sources their allocations well into the future (in some cases, indefinitely). In contrast, an auction forces participants to purchase near and long term allowances, begging the question as to how sources will recover these costs (of course, the ultimate bill is delivered to the customer who purchases the products).
- Market liquidity and diversity, will be relatively higher under a free allocation system and lower under an auction system. Giving a long term stream (e.g., thirty years worth) of allowances to covered sources will ensure that sources have a base amount of allowances which they can either use or sell. The availability of these allowances, especially at the outset of this program, allows sources to purchase on the spot market as well as execute puts, calls, leases, swaps, forward transactions for near term as well as future year allowances, all with variable terms and conditions and counter party credit quality. A government sponsored auction cannot hope to mimic or outperform a free allocation. Withholding such allowances, and making them only available through government sponsored auctions will have an opposite impact on liquidity.
- An allocation system allows for the healthy participation of both emitters and speculators. Giving sources allocations at the outset gives them a base amount which can be relied upon by emitters at the outset of the program and throughout its phases. In contrast, distributing allowances through an auction mechanism gives speculators, especially those with deep pockets, the opportunity to shut less well funded emitters out of the market. In this fashion, speculators can exercise market power that would be denied them under an allocation scheme.

- An auction severely disadvantages existing emitters over new sources with sunk costs and stranded assets. In an auction new entrants have the choice of tailoring their purchases and facility designs in perfect synchronization. Existing emitters have plants designed for an environment where polluting is free, and new entrants design their plant for the new environment, so auction discriminates against existing polluters who have a higher cost-base.
- An auction drains cash from emitters, resulting in less available capital to invest in reducing emissions. Expecting companies to invest to reduce emissions, at the same time as paying out cash for allowances in an auction, creates a cash-crunch. The result is a reduction in investment in reducing emissions.
- An allocation gives emitters the resources necessary to generate cash in the event that the holding source has found a way to reduce its greenhouse gas emissions. Invest in a pollution solution, use fewer allowances, and sell the surplus allowances to recoup the investment in pollution controls. In contrast, an auction simply puts sources in a cost minimization mode (they do what's necessary to acquire the least amount of allowances at the outset) rather than a profit maximization mode ('over-compliance' can free up allowances that can be sold) that comes with a free allocation.
- Under an allocation system, the market (rather than the state) chooses the winners. Those who can adjust their operations in a fashion that results in fewer emissions and those who elect to purchase allowances determine which solutions advance. This is preferable to the situation where a team of bureaucrats have the discretion to invest or otherwise spend money earned from an auction. A situation where there is no guarantee that the monies raised through an auction will be wisely invested to produce cost effective greenhouse gas reductions, or for that matter, not diverted to pay for some other state priority (i.e. highways, schools, prisons, etc.).
- Finally, it is worth commenting on a number of instances where the European experience of 'windfall profits' in the EU Emissions Trading Scheme (EU ETS), is quoted as an illustration of why free-allocation should be avoided. This is a significant misunderstanding of the situation in Europe, and we deem it sufficiently important for separate comment. Please note also that our comments are based on having been intimately involved in the design of the EU ETS through a number of boards and government committees, and the experience of being one of the principal centers of liquidity as a broker in the European market, and the synopsis of many analyst reports, some published and some not, into the EU ETS and electricity pricing.

In Europe, there was a small amount of over-allocation to particular industrial sectors in a small number of Member States, particularly in Eastern Europe. This was because some individual Member States were playing a game of using the EU ETS as a way of providing indirect subsidies to local industry, to better enable them to compete with industry in other Member States. The European Commission caught

most of these and slashed their allocations, but some slipped through.

Windfall profits from over-allocation were not material however. The material windfall profits were made in the electricity industry - the industrial sector which was universally under-allocated across Europe. Why was this? Many analysts say it was a demonstration of oligarchic market power in the European electricity industry, and a failure of electricity regulation. On average, European electricity generators received free allocations amounting to around 85% of their needs and had to buy the remaining 15% on the market. What they then did was raise all of their electricity prices by 100% of the marginal purchase cost of the allowances acquired – i.e. more than six times the average cost of the allowances actually employed. So they used emissions trading as an excuse to increase prices by more than costs, and thus secure windfall profits.

How were they able to do this? Many observers say that this occurrence is the clearest demonstration in a number of years that competition in the European electricity sector is not as fierce as the generators would have you believe. Thus windfall profits in the electricity sector are an issue for electricity regulation, not emissions trading. It is important to note that the ability to increase prices by more than costs is a function of regulation and competition, and independent of whether allowances are auctioned or allocated.

CantorCO₂e looks forward to receiving your feedback on this letter and to participating in future discussions with the board, its members, and staff. Please do not hesitate to call us at 415-296-9359.

Respectfully,

CANTORCO₂e, LP



Josh Margolis
Co-CEO