OFFICE OF THE GOVERNOR

March 16, 2017

Mary D. Nichols
Chair, California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: Request for Findings under SB 1018

Dear Chair Nichols:

On January 30, 2017, the California Air Resources Board (ARB) requested that I make findings, as required under Senate Bill 1018 (Gov. Code, § 12894(f)), relating to the proposed linkage of California's cap-and-trade program with the cap-and-trade program of the Canadian province of Ontario.[1] These findings do not presuppose any future direction from this Administration or the Legislature regarding the post-2020 design of the cap and trade program. The findings instead are a prerequisite to a formal linkage of the two programs.

Based on my review of the materials provided by ARB, as well as the thorough advice and counsel offered by Attorney General Becerra, I find that the four requirements of Government Code section 12894(f) are satisfied.

> **Finding 1**: Government Code section 12894(f)(1). The jurisdiction with which the state agency proposes to link has adopted program requirements for greenhouse gas reductions, including, but not limited to, requirements for offsets, that are equivalent to or stricter than those required by Division 25.5 (commencing with Section 38500) of the Health and Safety Code.

Division 25.5 (commencing with Section 38500) of the Health and Safety Code (Division 25.5) requires that greenhouse gas emissions in California be reduced to 1990 levels by 2020. And under 2016 legislation (Senate Bill 32), ARB was directed to use its authority under Division 25.5 to ensure that greenhouse gas emissions in California are reduced to 40 percent below 1990 levels by 2030. Additionally, Executive Orders S-03-05 and B-16-2012 set a 2050 target to reduce emissions in California to 80 percent below 1990 levels by 2050.

[1] https://www.arb.ca.gov/cc/capandtrade/linkage/linkage.htm

GOVERNOR EDMUND G. BROWN JR. • SACRAMENTO, CALIFORNIA 95814 • (916) 445-2841

Ontario's greenhouse gas reductions requirements are substantially similar to, and in some respects more stringent than, those required by Division 25.5. Ontario law sets the following targets for greenhouse gas emission reductions: (1) a 15 percent emissions reduction below 1990 levels by 2020, (2) a 37 percent reduction below 1990 levels by 2030, and (3) an 80 percent reduction below 1990 levels by 2050. Although these targets do not precisely track California's, Ontario's first target is lower than California's and California's long-term goal of 80 percent below 1990 levels by 2050 is already codified in Ontario. Accordingly, Ontario has adopted a program for greenhouse gas emission reductions that is equivalent to or stricter than Division 25.5.

Moreover, Ontario's cap-and-trade program is equivalent to California's, and at least as strict as required by Division 25.5, in the following respects:

- Ontario's climate programs apply to the same greenhouse gases as California's. In both programs "greenhouse gases" include: (1) carbon dioxide, (2) methane, (3) nitrous oxide, (4) hydrofluorocarbons, (5) perfluorocarbons, (6) sulfur hexafluoride, and (7) nitrogen trifluoride.
- In each jurisdiction, the cap-and-trade program covers more than 80 percent of sources of greenhouse gas emissions, and Ontario's program applies to some sources not covered by California's.
- The "cap" in each cap and trade program is designed to achieve additional reductions compared to a business-as-usual scenario.
- Compliance requirements for covered entities are substantially similar.
- Allowance allocations are also similar, and auctions will be conducted using the same platform and security measures. Offsets are approved according to the same rigorous criteria and oversight requirements.
- The two jurisdictions have similar reporting and verification requirements. The two jurisdictions have adopted similar protections against fraud, market manipulation, and price spikes.

Although Ontario has not yet completed its offset protocols, it has proposed a regulatory framework for offsets and is working to develop thirteen offset protocols that meet the criteria of Division 25.5. Specifically, offsets must be "real, quantifiable, permanent, enforceable, additional and verifiable."

Ontario also places the same limitations on the use of offsets for the compliance obligation of a regulated entity; both programs limit offsets to eight percent of the obligation. While Ontario uses a different mechanism to correct any failure or invalidation of an offset, the approach is equally effective. Like Québec, Ontario's program places the risk of a failure of offset integrity on the offset project developer. Pursuant to this requirement, if an offset is invalidated, the project developer must replace it. To ensure that offsets can be replaced, offset project developers must place offset credits in a buffer account so they are available if needed. In contrast, California requires the entity that surrendered the invalid offsets used for compliance to replace them. Although these approaches differ, both protect the program in the event that an offset is invalidated.

Because the Ontario program for greenhouse gas emissions reductions, including offsets requirements, is equivalent to or more stringent than Division 25.5, the requirements for the first finding are met.

> **Finding 2**: Government Code section 12894(f)(2). Under the proposed linkage, the State of California is able to enforce Division 25.5 (commencing with Section 38500) of the Health and Safety Code and related statutes, against any entity subject to regulation under those statutes, and against any entity located within the linking jurisdiction to the maximum extent permitted under the United States and California Constitutions.

Next, I am required to assess whether California can enforce Division 25.5 against California and Ontario entities that participate in the auctions consistent with the Constitutions of the United States and California. This finding can be made because the proposed linkage with Ontario does not restrict the reach of California's enforcement authority. Specifically, the linkage will not limit the State's ability to enforce Division 25.5 against entities located in California or Ontario, consistent with constitutional requirements.

All entities that participate in the California program, including offset providers, must register with ARB and by doing so consent to the jurisdiction of California courts. The linkage does not alter this consent process. California will be able to enforce its program against all entities participating in the California auction whether or not the program is linked with Ontario.

If an Ontario entity registers with Ontario's program, but not California's, it still would be subject to California jurisdiction to the extent allowed by the Constitution. As explained by the Attorney General, Ontario businesses may be subject to jurisdiction in California if, for example, they are "entities doing business in California, entities knowingly selling fraudulent compliance instruments to a California entity with a California compliance obligation, and any other entities with conduct 'expressly aim[ed]' at California." In most cases, therefore, California would be able to bring enforcement actions against Ontario companies even if they are only registered with Ontario's program because any wrongful conduct affecting California's program likely will be sufficient to establish the minimum contacts for California jurisdiction. And if California were to lack jurisdiction over an entity in Ontario, Ontario possesses adequate tools to address harm caused by violations in Ontario.

Accordingly, the second finding can be made.

> **Finding 3**: Government Code section 12894(f)(3). The proposed linkage provides for enforcement of applicable laws by the state agency or by the linking jurisdiction of program requirements that are equivalent to or stricter than those required by Division 25.5 (commencing with Section 38500) of the Health and Safety Code.

Ontario's cap-and-trade program and environmental statutes provide Ontario with sufficient enforcement authority to ensure that its program requirements are met. That authority is equivalent to and in some respects stricter than California's authority to enforce Division 25.5 and its implementing regulations. Like California, Ontario has the ability to bring civil, criminal and administrative enforcement actions to compel compliance with the cap-and-trade program.

Ontario also has subpoena authority that is equivalent to California's, giving it the authority to seek information to support enforcement actions.

The provisions of Ontario's cap-and-trade program governing violations of reporting requirements and surrendering of allowances and offsets are substantially identical to California's. Ontario has mechanisms designed to ensure that violations of its cap-and-trade program do not endanger the program's emission-reduction goals. For example, like in California and Québec, regulated entities in Ontario that fail to turn over sufficient compliance instruments must surrender three allowances or offsets for every one that is required, but not surrendered. This deterrent is built in to the allowance tracking systems of both programs, effectively making it automatic in both jurisdictions. In addition, civil penalties may be assessed under both programs and trade restrictions may be placed on non-compliant entities. In some cases, Ontario's penalty provisions allow for higher penalties. Finally, Ontario's statutes authorize Ontario to guard against fraud and misrepresentation in a manner similar to California.

In sum, Ontario's enforcement authority is equivalent to or stricter than California's, enabling me to make the third finding.

> **Finding 4:** Government Code section 12984(f)(4). The proposed linkage and any related participation of the State of California in Western Climate Initiative, Incorporated, shall not impose any significant liability on the state or any state agency for any failure associated with the linkage.

The Attorney General explains that the proposed linkage would not affect existing immunity of the state and state employees for ARB's discretionary policy decision to link the cap-and-trade program with Ontario's. The fourth finding can be made because the linkage would not alter existing immunities.

Additionally, the Attorney General also notes that certain historical problems in other carbon markets, such as the European Union's trading system, arose from "uneven security measures among participating jurisdictions, and disparate tax treatment of compliance mechanisms, which are not present in the Ontario market." Like Québec's program, Ontario's program will be implemented with the same strict oversight and structural integrity as California's.

Additionally, the State's participation in WCI, Inc. will not result in any significant liability. This finding was made previously when California linked its program with Québec. Like Québec, Ontario is a member of WCI, Inc. and will use the same WCI, Inc. infrastructure used by California and Québec. This participation will help to ensure that the linked market is secure and maintained with the high standards developed by California for its own auctions. As indicated by the Attorney General, California's participation in WCI, Inc. "is more likely to shield the state from liability than subject it to liability."

Additional Steps

These findings represent the statutory minimum that must be satisfied in order for California to link its program with the province of Ontario, Canada. ARB staff has proposed an amendment to

its cap-and-trade regulation to provide for linkage with Ontario, which is scheduled for consideration by the ARB board in June, 2017 and would not become effective until January 1, 2018.

These findings are based on the understanding that Ontario will be added to the linkage agreement between California and Québec regarding harmonization and integration of the cap-and-trade programs. This agreement currently details procedures between ARB and the Québec Minister of Environment for ongoing coordination between the two programs, including monitoring changes to offset protocols or adoption of new protocols. The parties intend to modify and expand the agreement, including to add Ontario. Any changes to the California program prior to final adoption by the ARB board will be discussed and considered by the three jurisdictions, and parallel changes to the Canadian jurisdictions' requirements will be made if necessary, together with amendments to the linkage agreement.

After adoption of the regulation and before the effective date of the linkage, ARB, Québec and Ontario will test and evaluate their auction platforms and trading systems to ensure that they are fully compatible and ready to be implemented.

Before linkage becomes effective, ARB should follow the same procedures that were followed prior to the linkage with Québec, including a report to the Secretary of the California Environmental Protection Agency and to the Governor's Office, by November 1, 2017, on the progress of the above efforts and whether there are any impediments to linkage occurring in January, 2018.

Sincerely,

Edmund G. Brown Jr.