Coalition for Emission Reduction Policy
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COMMENTS ON THE PROPOSED AMENDMENTS TO THE CALIFORNIA CAP ON GREENHOUSE GAS EMISSIONS AND MARKET-BASED COMPLIANCE MECHANISMS TO ALLOW FOR THE USE OF COMPLIANCE INSTRUMENTS ISSUED BY LINKED JURISDICTIONS

Submitted by:

Coalition for Emission Reduction Policy (CERP)

Submitted to:

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Introduction

The Coalition for Emission Reduction Policy (CERP)[1] appreciates this opportunity to provide comments on the Air Resources Board's (ARB) proposed modifications to the Cap-and-Trade Regulations to facilitate linkage of California's program with Québec. CERP exists to educate policymakers and the general public about the benefits of using market-based approaches in policies to address emissions of greenhouse gases (GHGs). CERP brings together leading companies from the energy, financial services, and emissions reduction project development sectors. A list of members is included in Appendix A of these comments.

CERP supports the goal of ensuring that California creates an environmentally rigorous and highly functional offset system which will assist in containing the costs of achieving A.B. 32 emission limits and serve as a model for other regional and federal greenhouse gas regulatory programs. CERP believes that while linkage of the California cap-and-trade program with Québec could benefit California over time, it is crucial that such linkage be done in a thoughtful manner that does not jeopardize California's nascent program. CERP offers the following comments and suggestions on the rulemaking:

I. Amendments to Rules Governing Transfers of Compliance Instruments

A. ARB Should Consider Alternatives to the Proposed "Push-Push-Pull" Procedure for Transfers of Compliance Instruments

CERP appreciates that it is imperative for ARB to establish a secure and reliable procedure for conducting transfers of compliance instruments, especially in light of recent instances in the European Union Emissions Trading System (ETS) in which large numbers of compliance instruments were fraudulently transferred. A properly functioning transfer procedure should ensure that no transfer is undertaken unless authorized by bona fide representatives of both the source and destination accounts for the compliance instruments. Equally essential, however, is that the transfer procedure minimize the transaction costs for registered entities and avoid undue delays in the conduct of trading. Unnecessary friction in carrying out transfers will impair or discourage economically efficient trading and, ultimately, increase the costs of the cap-and-trade program to covered entities and California residents.[2]

[1] For more information about CERP, see www.uscerp.org.
[2] *See* Recommendations of the Market Advisory Board Committee to the California Air Resources Board at H-22 (June 30, 2007) (identifying minimization of transaction costs as a key design principle for the ARB cap-and-trade program).

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With these principles in mind, CERP questions whether ARB's proposed "push-push-pull" procedure[3] – under which a transfer would require independent confirmation from two representatives of the source account as well as one representative of the destination account – is the best approach for ensuring the integrity of compliance instrument transfers. Many registered entities, including both covered entities and voluntarily associated entities, are likely to engage in large numbers of transfers of compliance instruments on a continuous basis. Entities that are highly active in trading will likely find it impractical to have two account representatives confirm every individual transaction. Such entities are likely to rely upon their own internal accounting and trading procedures to track the disposition of compliance instruments, rather than a cumbersome multiple confirmation procedure. CERP further notes that the regulations governing trading of sulfur dioxide allowances under Title IV of the Clean Air Act do not require a "push-push-pull" approach.[4] To our knowledge, the Title IV procedure has not resulted in any notable erroneous or fraudulent transfers.

Accordingly, CERP encourages ARB to consider, and take comment on, other approaches that could achieve the goals of the "push-push-pull" procedure. As a preliminary matter, ARB's Know-Your-Customer (KYC) requirements provide ample confirmation of the identity of individuals with access to the tracking system – and are themselves a valuable safeguard against unauthorized transfers. An additional safeguard that ARB could propose in lieu of "push-push-pull" could include automatic notifications to all account representatives and viewing agents for a registered entity that initiates a transfer request. Such a measure would give owners of compliance instruments ample notice and opportunity to stop an unauthorized transfer.

B. If ARB Retains the "Push-Push-Pull" Procedure, It Should Modify the Deadlines and Penalty Provisions

In the event ARB proceeds to finalize the "push-push-pull" procedure, it should make the following changes to better accommodate the needs of market participants:

- **Allow three *business* days for confirmation of transfers.** ARB proposes that an account representative for the source account confirm a transfer within two calendar days of initiating a transfer request, and that an account representative of the destination account confirm within three calendar days of initiating a transfer request.[5] These deadlines could prove burdensome or even impossible to meet if the accounts administrator is not operational on weekends or holidays.

[3] Proposed § 95921(a)(1).
[4] 40 C.F.R. § 73.50(b) (requiring that allowance transfer requests be signed by one account representative for the transferor account and one account representative for the transferee account).
[5] Proposed § 95921(a)(1)(B), (E).

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Accordingly, CERP recommends that the deadlines be expressed in *business* days, not calendar days.

- **Remove penalties for non-compliance with transfer procedure.** ARB proposes to find *both* parties to a transfer in violation of the cap-and-trade regulations, and potentially apply penalties, if the deadlines for completing transfer requests are not met.[6] CERP believes that applying penalties in such circumstances could unfairly punish one or both parties to a transaction for inadvertent lapses in completing a transfer request. By creating additional enforcement and compliance risks for registered entities, the threat of penalties could also "chill" legitimate trading activity. Further, ARB has not established that such penalties are necessary: at this early stage of implementation, it is not clear that large-scale initiations of delayed or uncompleted transfer requests are likely to occur. Nor has ARB explained how delayed or uncompleted transfer requests would harm the trading system.[7] Absent such an explanation, CERP recommends that the regulations simply provide that a transfer request will automatically expire if the confirmation deadlines are not met.

II. Changes to Holding Limits

CERP opposes ARB's proposal to require holding limits to be calculated separately for *each* future vintage year.[8] This proposal would greatly increase the complexity of monitoring compliance with the holding limits for entities that acquire allowances from future vintage years. Moreover, it is not clear that any market flaws would result from the accumulation of allowances within a single future vintage year. Rather, ARB suggests that the proposal is driven by the concern that registered entities that acquire future vintage allowances may have difficulty complying with the holding limit once those future vintage allowances become current year allowances.[9] This, however, is an entirely foreseeable compliance issue that registered entities are capable of addressing on their own by adjusting their account balances over time. It is neither necessary nor desirable for ARB to address this concern by imposing an arbitrary and complex set of vintage-specific holding limits for acquisitions of future vintage allowances.

III. Requiring an Account Representative or Agent for Service of Process in California is Unnecessary and Potentially Burdensome

CERP questions the need for ARB's proposed requirement that voluntarily associated entities either designate an account representative with a primary residence in

[6] Proposed § 95921(a)(3).
[7] To the extent that ARB is concerned such requests could serve as a vehicle for manipulation or fraud, CERP notes that the regulations already provide ARB ample authority to punish any trade "involving, related to, or associated with" manipulative, deceptive, or fraudulent activity. § 95921(f)(2).
[8] Proposed § 95920(e).
[9] ISOR at 196.

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California or designate an agent for service of process in California.[10] This requirement appears unnecessary for enforcement purposes, because any voluntarily associated entity that resides in the United States, registers with ARB, and participates in ARB's cap-and-trade program should have the requisite minimum contacts with the state of California needed for ARB to exercise its enforcement powers.[11] Any remaining concerns over enforceability could be addressed by requiring voluntarily associated entities to consent to service of process on any United States-based agent designated by those entities during the registration process.

We appreciate that ARB may be concerned about the *costs* of exercising its enforcement powers through the long-arm statute. However, ARB's proposed approach shifts substantial costs to voluntarily associated entities – many of which may be smaller developers of offset projects. These small entities would have to specially designate a California-based agent for service of process, and this raises the cost of participation in the cap-and-trade program and creates additional administrative burdens, without enhancing the enforceability of ARB's regulations.

IV. Know-Your-Customer Requirements Should Not Compel Submission of Bank Account Information

As noted above, ARB has included "Know-Your-Customer" (KYC) requirements in the revised regulations. The KYC provisions contain requirements that an entity must meet before it can receive access to the tracking system.[12] The provisions require every individual to provide documentation of their name, photograph, date of birth, primary address and driver's license or passport number. The name, address and contact information of their employer must also be presented. CERP believes that in large part these requirements are sensible and serve to protect the cap-and-trade system from fraud or misuse. However, in one instance CERP notes that the KYC requirements seem excessive. In the proposed regulation, individuals must provide an open bank account number in addition to other forms of identity confirmation.[13] Requesting such private information raises understandable security concerns; moreover, there are alternative and perhaps more effective ways to confirm an individual's identity than through bank account information. CERP urges ARB to omit this requirement in a final rule.

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[10] Proposed §95830(c)(4), (5).

[11] California's "long arm statute" is among the broadest in the country, authorizing California courts to "exercise jurisdiction on any basis not inconsistent with the Constitution of this state or of the United States." CAL. CIV. PROC. CODE § 410.10 (2012). There is no reason to believe that a voluntarily associated entity registered with ARB would not have the continuous and purposeful contact with California that is required to exercise personal jurisdiction under this statute and the standards of the U.S. Constitution. *See, e.g., International Shoe v. State of Washington,* 326 U.S. 310, 320 (1945).

[12] Proposed §95834(a)(1).

[13] Proposed § 95834(b).

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V. Offset Regulation

Québec's offset regulations were published in early June and ARB added them to the rulemaking docket on June 11.[14] We appreciate that ARB has made such documents available for review. As ARB noted, it appears that most of Québec's offset regulations are the same or very similar to California's approach.

However, one area in which the offset regulations for the two jurisdictions differ is in their approach to liability for invalidated offset credits. California has adopted a "buyer liability" approach wherein the entity that surrenders an offset credit for compliance must replace it with another valid compliance instrument if the credit is invalidated. In contrast, Québec proposes that invalidated offset credits be remediated by canceling an equal quantity of offset credits held in an "environmental integrity account." Every offset project would contribute a small percentage, approximately 6% of its total issued offsets,[15] into the environmental integrity account – thereby providing a form of advance insurance to protect the integrity of Québec's emission trading system. In addition, Québec proposes to grant the Minister of Sustainable Development, Environment, and Parks discretionary authority to require an offset project developer (or "offset promoter" in Québec's regulatory terminology) to replace invalidated credits with valid compliance instruments. These discretionary replacements, and cancelations from the environmental integrity account, will together cover any losses arising from offset project reversals or fraudulent credits.[16] CERP and many other organizations recommended that ARB adopt such a buffer account as an alternative to the buyer liability approach.

To be sure, challenges and inefficiencies may arise if Québec and California adopt divergent approaches to assuring the integrity of offset credits across the WCI. Because Québec proposes to employ an approach to offsets invalidation that does not create buyer liability, covered entities throughout the WCI region will likely gravitate to offsets issued by Québec. Conversely, offset credits issued by California may be comparatively less attractive to buyers in light of their uncertain risk for invalidation liability. If different systems of invalidation liability persist, the emergence of a fragmented market with differential pricing of offset credits is very likely – distorting the efficiency and effectiveness of the broader WCI market.

Despite this potential for market discrepancies, CERP also believes the operation of two systems for insuring offset integrity could also provide a valuable "test run" of alternate models. Assuming Québec proceeds to adopt an environmental integrity account, we recommend that ARB use this opportunity to monitor and assess the performance of this approach. Ultimately, CERP believes that over time it will be important to harmonize

[14] Cap-and-trade system for greenhouse gas emission allowances—Amendments, found at: http://www.arb.ca.gov/regact/2012/capandtrade12/qcaamendpt2.pdf
[15] Cap-and-trade system for greenhouse gas emission allowances—Amendments, at p. 29
[16] ISOR at 36, Cap-and-trade system for greenhouse gas emission allowances—Amendments, at p. 29.

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the offset invalidity approaches. Thus, CERP urges ARB to use the first few years of market operation to assess the buffer account employed by Québec, and after gaining assurances of its performance, to consider adopting a similar approach in California.

VI. Additional Offset Comments

In addition to addressing changes to the regulations, CERP again urges ARB to make public the timing of additional offset protocols. As we have noted before, this information will assist the market in planning and assure covered entities that sufficient offset supply will exist as the market gets underway. New protocols will be crucial for ensuring sufficient supply of offsets in the cap-and-trade system, especially in the second and third compliance periods. CERP therefore requests that ARB make public additional information on the schedule for consideration of new offset protocols. It would be helpful if ARB announces a date for the offset workshop on new protocols, and signals when those engaged in the market can look forward to seeing such new protocols introduced.

Offset projects take significant time to complete and therefore new offset protocols must be introduced as early as possible so that project development may begin in a timely manner and offset credits may be generated. The disclosure of further information regarding ARB's process and timing is especially important to project developers who are trying to determine whether to invest significant capital in new project types and who need signals concerning what protocols will likely be accepted and able to earn ARB credits. As we have stated previously, even if ARB can only provide a tentative indication of protocols under consideration, such a message can be helpful. The market is comfortable making advance investments around such conditional information. Any new information that ARB can provide the public with regard to their process for offset system development will be helpful in preparing the cap-and-trade market to begin operation.

Conclusion

We appreciate your consideration of our comments. Please let us know if you would like to discuss these concepts, or would like further explanation of any of these suggestions. We look forward to continuing to work with you to ensure that the California offsets program is effective, efficient, and environmentally rigorous.

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Appendix A

Members of the Coalition for Emission Reduction Policy (CERP)

American Electric Power

C Trade

Duke Energy

PG&E Corporation

Camco

Deutsche Bank

Verdeo Group

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