

Proposed Linkage of California's Cap-and-Trade Program With the Canadian Province of Québec's Cap-and-Trade Program

General Summary of Comments and Preliminary Agency Responses

1. INTRODUCTION

This document supports the Air Resources Board's (ARB/Board) request to the Governor for review and approval of specific findings that must be made to allow for the formal linkage of California's Cap-and-Trade Program with the Canadian Province of Québec's Cap-and-Trade Program. These findings are required pursuant to Senate Bill (SB) 1018.¹ This bill included provisions intended to ensure that any decision to link market-based compliance programs under Assembly Bill (AB) 32 with a program in another jurisdiction would occur only after the Governor reviews and issues four specific findings and submits those findings to the Legislature.

In support of linking programs with Québec, ARB staff released an Initial Statement of Reasons (ISOR) on May 9, 2012. The ISOR provided a basis and rationale for the proposed amendments. These amendments were scheduled to be considered at the June 28, 2012, public hearing. On June 11, 2012, ARB staff released the first Notice of Public Availability of Additional Documents and Information. After ARB released the ISOR, the Legislature enacted SB 1018. As discussed above, linkage cannot proceed unless and until the specified findings have been made.

Consequently, at its June 28, 2012, public hearing, the Board deferred action on the regulatory amendments related to linkage and directed the Executive Officer to formally request that the Governor make the required findings and provide those findings to the Legislature.²

On January 8, 2013, ARB staff released the second Notice of Public Availability of Modified Text and Availability of Additional Documents and Information. The public notice provided background and support for ARB's future request that the Governor make certain findings as a predicate to linking the two programs.

During both the 45-day public comment period and the 15-day public comment period in January 2013, the public submitted comments on the staff proposal. In addition, oral comments were submitted on the linkage proposal at the June 28, 2012, public hearing. The regulatory amendments for linkage were part of other

¹ Senate Bill 1018 was chaptered on June 27, 2012. Statutes 2012; Chapter 39; Codified in Government Code section 12894.

² Air Resources Board Resolution 12-28, June 28, 2012.

regulatory amendments to the Cap-and-Trade Regulation that the Board considered at the June public hearing. Therefore, all of the written and oral comments submitted prior to, and at the June public hearing, are summarized in the Final Statement of Reasons (FSOR) that was completed in July 2012.³ However, as action was deferred on the linkage regulatory amendments, the responses to the linkage-related comments identifies that no action was taken on those proposed amendments. A separate FSOR will address the linkage related amendments, including comments submitted on the 15-day notice released in January 2013.

This document is intended to provide a broad characterization of the comments that have been submitted to date on the proposed linkage rule amendments. The submitted comments do not raise issues regarding any of the four areas upon which the Governor must make findings pursuant to SB 1018. The Board has not yet considered the regulatory amendments for linkage and will do so only after the Governor has issued the necessary findings and submitted those findings to the Legislature. The earliest possible date for Board consideration is the March 2013 Board hearing. Consequently, there may be additional comments submitted at this hearing, and the agency responses provided in this document, by necessity, must be considered preliminary pending final Board action.

It is important to note that ARB staff has been working successfully with Québec staff for several years to harmonize the regulations. Both jurisdictions are now ready to act. As with many states and provinces, Québec is too small to act alone. Therefore, linking now is an important step that allows Québec's program to proceed. Furthermore, California's action would help to advance efforts to address climate change through coordinated sub-national efforts to catalyze action throughout the country and the world.

II. General Characterization of the Comments

There were 25 commenters that submitted comments during the public comment periods either individually or part of a joint letter submittal. The 45-day comment period began on May 9, 2012, whereas the first 15-day comment period began on June 11, 2012, with the second 15-day comment period beginning on January 8, 2013. A list of commenters is presented in Attachment 1. Fourteen commenters represent industries directly affected by the regulations; nine commenters represent environmental organizations; and two represent interests in carbon offsets.

Almost all of the commenters expressed support for a broad-based market. These commenters viewed the effort as a transformative step for North America and as a catalyst for other jurisdictions to address climate change. They also recognized that it is critically important to ensure the ongoing environmental

³ Air Resources Board, Amendments to California's Cap-and-Trade Program, Final Statement of Reasons, July 2012.

integrity of California's Cap-and-Trade Program. ARB staff agrees that this is of paramount importance.

The balance of the comments submitted to date can be characterized as listed below:

1. Linkage with Québec is premature;
2. Carbon offset issues must be addressed;
3. Linkage may adversely impact costs and market structures; and
4. Transparency and program monitoring are essential.

Each of these four categories is discussed in the following sections, along with a preliminary agency response.

III. LINKAGE WITH QUÉBEC IS PREMATURE

A. Establish a Track Record

Prior to linking, commenters indicated that both California and Québec should establish a track record demonstrating that the markets can run effectively and efficiently, issues associated with linkage have been fully vetted, some practical experience with the respective cap and trade programs has been gained, consistent rules and enforcement policies are established, and there is evidence that linkage can help to contain the costs of the linked programs. Supporting that comment, they identified that there was only limited operational experience in California and the Québec program had only recently been finalized in December 2012.

Several commenters referred to a September 2012 Issues Paper from the Emissions Market Assessment Committee (EMAC) entitled "Linkage with Québec in California's Greenhouse Gas Emissions Cap-and-Trade Market" (EMAC Report).⁴ The EMAC was established as part of an ARB contract and consists of four academic researchers charged with providing independent advice to the ARB on the Cap-and-Trade Program. In its report, the EMAC recommended that:

"To harness the greatest benefits from linking with other GHG C&T markets and still ensure the integrity and viability of California's market, linkage with Québec should be considered once each market is found to be well-functioning."

⁴ Elizabeth M. Bailey, Severin Borenstein, James Bushnell, and Frank A. Wolak, Emissions Market Assessment Committee for AB 32 Compliance Mechanisms (EMAC), "Linkage with Québec in California's Greenhouse Gas Emissions Cap-and-Trade Market," September 20, 2012.

Some commenters concluded that linking now would simply make the program more complex and add additional uncertainties to how the programs will operate in practice.

Preliminary Agency Response: ARB staff recognizes that both programs have limited operational experience. However, linking with Québec now is consistent with the AB 32 requirement to facilitate the development of integrated and cost-effective regional, national, and international greenhouse gas reduction programs.⁵ Furthermore, the notion raised by several commenters that California and Québec should proceed independently for a few years to work out program bugs ignores the fact that Québec is too small to proceed alone. In fact, almost all of the states and provinces in the United States and Canada are too small to implement cap-and-trade programs on their own to reduce GHG emissions. Failure to link now could setback not only Québec's participation, but California's interest in an expanded program.

Linking with Québec also has several advantages. The reduction of greenhouse gas emissions that can be achieved collectively by the two programs is larger than what can be achieved through a California-only program. Broadening the scope of the market will also provide greater flexibility to California businesses by encompassing a wider range of emissions reduction opportunities and greater market liquidity, and may have a positive impact on the California economy. Furthermore, the experience gained now in demonstrating that two separate governments, in two separate countries, with two separate economies, can effectively partner to put a price on carbon and reduce greenhouse gas emissions is invaluable in accelerating national and international efforts to address climate change.

Relative to the EMAC Report, ARB staff has held two auctions to date and will have held at least one more prior to a potential first joint auction with Québec. In that time, there will have been sufficient time and opportunity for price discovery. This information will help California regulated entities better understand their abatement opportunities and costs prior to fully participating in a linked market program.

Staff from both jurisdictions has spent considerable time ensuring consistency of definitions and market rules for the use of compliance instruments and understanding each other's enforcement mechanisms and regulations. This coordination is critical to ensure equivalence in the enforceability of market mechanisms and overall compliance. Staff from both jurisdictions is closely coordinating on the development of a formal Linkage Agreement. The purpose of the Linkage Agreement is to define the manner in which the operation of the programs is coordinated among

⁵ Assembly Bill 32, section 38564.

the jurisdictions. The Linkage Agreement will support consistency and transparency of market mechanisms and compliance.

B. Resolve Harmonization Issues

Commenters noted several areas of the two regulations where they believed harmonization of specific provisions needed to occur prior to linkage to ensure that linkage does not have an adverse effect on covered entities. These include areas such as the administration of allocations, definitions, industry benchmarks, the regulation of refining units, auction dates, and the inconsistent treatment of combined heat and power units that do not receive free allocations.

Several commenters also noted that there were outstanding issues associated with California's regulation that needed to be addressed prior to linking with Québec. These include electricity issues, primarily resource shuffling, the position of publically-owned utilities that are interconnected with the California Independent System Operator, and the treatment of electricity imports. Others noted that the Québec regulations were not nearly as detailed as the California regulations, thus raising the question as to whether they were, in fact, substantially similar. One commenter cited an example that California has 288 specific definitions in their regulations, whereas Québec only has 15.

Preliminary Agency Response: ARB staff has spent a considerable amount of time reviewing and comparing the effectiveness of Québec's regulation to California's regulation. Each jurisdiction will have its own unique requirements and mandates relative to the implementation of its own program, its own existing regulatory structure, and its own rulemaking requirements. For example, ARB staff agrees that the Québec regulation is not as detailed and specific as the California regulation. However, the challenge is to ensure that the critical provisions of the program, including implementation, are effectively harmonized. Based on its review, ARB staff is confident that the programs are effectively harmonized.

Note that the Board has directed ARB staff to propose future regulatory amendments in response to some specific stakeholder concerns such as resource shuffling. ARB staff will continue to coordinate with Québec staff on the development of these amendments to ensure harmonization. Other concerns related to existing technical design features of California's program, such as holding and purchase limits, have already been discussed and addressed in the FSOR published in October 2011.⁶

⁶ Air Resources Board, Amendments to California's Cap-and-Trade Program, Final Statement of Reasons, October 2012.

C. Develop Criteria for Linking and De-Linking

Commenters urged ARB staff to develop procedures for both linking with other jurisdictions and de-linking with other jurisdictions in the event a linked jurisdiction's program no longer was equivalent, or for other reasons. These procedures would identify the criteria ARB staff would use in the respective evaluations and reduce the uncertainties associated with the evaluations. Relative to de-linking, such procedures would reduce the uncertainty regarding the fungibility of compliance instruments, discourage a linked jurisdiction from making substantial changes to its own cap-and-trade program that potentially weakens the program, and address potential stranded costs.

Preliminary Agency Response: The ISOR for the rulemaking provides a clear scope of the level and type of review that staff conducted prior to proposing linkage with Québec. The Western Climate Initiative (WCI) partners have already agreed on high level recommendations for the design of each jurisdiction's program to allow for comparable criteria. Each potential future linkage will include the same review and stakeholder process used in this rulemaking prior to ARB staff seeking the Governor's review and findings pursuant to SB 1018, and Board action to formally link with another program.

The same level of review and evaluation would also apply to a de-linking evaluation, including the need for regulatory action. Furthermore, ARB staff will be closely monitoring other jurisdiction's implementation of their own programs and the Linking Agreement will lay out the process for continued coordination once the programs are linked. These procedures will help flag and resolve potential issues prior to the need for formal de-linking action. While staff understands the concern about impermanence of compliance instruments in the case of de-linking, there cannot be a guarantee for the continuing fungibility of those instruments because staff cannot pre-suppose Board action. However, staff expects that previously issued Québec compliance instruments would continue to be eligible for use in the California program.

IV. CARBON OFFSET ISSUES MUST BE ADDRESSED

A. Enhance Offset Availability

There were several comments related to availability of offsets. Commenters noted that a linked program should result in an increase of the availability of offsets to avoid increasing demand for the limited number of offsets that will be generated pursuant to the California program. To that end, the recommendations included urging California to adopt an offset protocol similar to Québec's landfill destruction protocol, urging Québec to adopt protocols similar to California's two

forestry protocols, and encouraging both jurisdictions to put a high priority on investigating and adopting additional protocols.

One commenter noted that Québec's Climate Action Plan 2012 could lead to the regulation of ozone depleting substances, including refrigerants and foam blowing agents, in a manner that would prevent any offset credits from being issued in Québec. Due to additionality requirements, this action would mean that offset projects located in the United States, its territories, Canada, and Mexico could not be used in California and its linked jurisdictions to meet compliance obligations. To address this situation, several commenters suggested that California amend its regulation to require all linked jurisdictions to use ARB protocols.

Preliminary Agency Response: Staff recognizes stakeholder concerns regarding offset supply. The Board must adopt all offset protocols used in the compliance program after undergoing a full regulatory process, including an ARB stakeholder process, in accordance with the Administrative Procedure Act, and an environmental review. The details surrounding any new offset project types for which ARB adopts an offset protocol will be dealt with under that specific rulemaking, and modification will be made to the Cap-and-Trade Regulation as needed.

California will explore, in conjunction with WCI partner jurisdictions, additional opportunities for emissions reductions from offsets in order to ensure a sufficient offset supply is available to contain costs. On May 17, 2012, WCI announced that it will review and evaluate additional offset protocols, including protocols relating to fugitive coal mine methane and small landfills. The WCI may also consider reviewing additional protocols relating to fertilizer application N₂O emission reductions, rice cultivation, and enteric fermentation. Note that California did not develop a landfill protocol because analysis showed little additional reductions above California's landfill regulation. Furthermore, Québec's landfill protocol only applies to sources that are not covered by California's landfill regulations. Québec is not proposing a forest or urban forest offset protocol at this time.

B. Ensure the Integrity of Offsets

Several commenters expressed concerns about the need to develop an ongoing process to evaluate any changes to offset protocols that may occur after linkage. This process would ensure that Québec's offset protocols, and the offsets protocols of any jurisdiction with which California shall link in the future, meet the requirements of AB 32. These requirements specify that offsets credits be real, permanent, quantifiable, verifiable, and enforceable, additional to what would have otherwise occurred, and represent a no lesser reduction in GHG emissions than a California compliance instrument.

Preliminary Agency Response: ARB staff shares the concerns about maintaining the integrity of the offset program, but does not believe separate procedures are necessary at this time. ARB staff will monitor the application of the offset protocols, as well as the modification to any protocols. ARB staff and Québec staff is committed to working closely together to resolve any potential issues. However, if staff identifies that potential changes to the Québec offset protocols could harm attainment of the overall program goals, staff would brief the Board and pursue the Board's direction.

In addition, the Linkage Agreement will formalize the manner in which the operation of the programs is coordinated between California and Québec. One of the provisions of the Linkage Agreement will highlight the coordination necessary to consider program modifications, including new or revised offset protocols.

C. Reconsider the Approach to Replace Invalid Offsets

Commenters noted that there is a difference between the two programs in how invalid offsets would be replaced. 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. Québec requires that invalidated offset credits be remediated by canceling an equal quantity of offset credits held in an "environmental integrity" account. In addition, Québec has provided some discretionary authority to require an offset project developer to replace invalidated credits with valid compliance instruments.

Some commenters indicated that these differences may lead to fragmented markets with differential pricing of offset credits. As a result, the efficiency and effectiveness of the broader offset market would be distorted. However, there was some recognition that this would be a valuable "test run" of alternate models and that, over time, it would be important to harmonize. Others indicated that California should simply adopt Québec's rule regarding the replacement of invalid offsets as they believe this approach will provide greater certainty in the offset market and thus strengthen the program as a whole.

Preliminary Agency Response: ARB staff believes that jurisdictions can pursue different, but equally effective, methods to ensure the environmental integrity of offsets. The objective is to ensure that invalid offsets are identified and replaced. ARB staff's analysis of the Québec program indicates that there are sufficient safeguards to ensure that invalid credits will be identified and replaced and enforcement action will be taken against those who violate any of the Québec protocols. ARB staff continues to believe that requiring the user to replace invalidated offsets ensures that purchasers and users of offset credits do their due diligence in seeking out high-quality offset credits.

Staff will continue to monitor the offset market and evaluate whether there is any distortion in the market occurring due to the different approaches used for replacing invalid offsets. If any distortions are identified, staff will consider appropriate action at that time.

D. Linkage May Result in Adverse Environmental Impacts

Several commenters expressed concerns that linking the Cap-and-Trade Programs will force California to accept carbon offset credits from projects with low or no environmental standards, thereby leading to substantial negative environmental impacts. Forest projects were identified in particular. In addition, concerns were raised about the structure of the regulation that commits California to accept future offset credits from protocols that have not yet been developed, as well as any offset credits issued by any other jurisdictions to which we link our Cap-and-Trade Program. According to commenters, under these provisions, California would be forced to accept offset credits generated under offset protocols with lesser environmental standards than the offset protocols that California adopts, even when the offset projects in other jurisdictions result in significant negative environmental impacts. The commenters maintain that ARB's ISOR fails to acknowledge or analyze the potential environmental impacts of projects that will generate offset credits that become part of the California market.

Preliminary Agency Response: The proposed amendments to the regulation currently under consideration would link the California market program only with Québec's market program. Staff's analysis found Québec's offset program to be consistent with WCI recommendations and consistent with California's compliance offset program. Québec does not currently have, nor is currently proposing, to develop or adopt a forest protocol. Québec's protocols are discussed in the Staff Report. Chapter IV of the ISOR includes an analysis of the potential indirect environmental impacts associated with implementation of those protocols and Appendix C of the ISOR includes a table that depicts Canada's environmental protections that are in place at the national and provincial level.

ARB has also been coordinating with its WCI Partner jurisdictions to develop and approve the document entitled "Final Recommendations - Offset System Process."⁷ This document sets forth agreed upon recommendations for reviewing and approving offset projects and creating credits in state and provincial greenhouse gas emissions trading programs. In addition, the Linkage Agreement will describe how ARB and Québec will consult in the development of new protocols and modification of existing protocols.

⁷ Western Climate Initiative, Final Recommendations Offset System Process, February 22, 2012; available at: <http://www.westernclimateinitiative.org/news-and-updates/143-final-recommendations-offset-system-process-available>.

As far as concern about future changes to the Québec program, once California is linked to its program, staff plans to provide the Board an update prior to any adoption of a new protocol in Québec. This update at a public meeting of the Board will provide stakeholders the opportunity to discuss any concerns about the proposed action by Québec before there is formal inclusion of a protocol by the linked program.

Any proposal to link with another jurisdiction will involve a full rulemaking process with an opportunity for stakeholders to provide comment. The ISOR for any proposal to link with another jurisdiction would include a full analysis of that jurisdiction's program, including an analysis of the jurisdiction's offset program and an environmental analysis. ARB is not, at this time, with the current proposed amendments to link with Québec, committing California to buying offset credits out of a "black box" of protocols from other jurisdictions.

V. LINKAGE MAY ADVERSELY IMPACT COSTS AND MARKET STRUCTURES

A. Establish A More Robust Market

There were several comments that discussed the need to establish a more robust market. One concern was that the relative size of the Québec market was too small to achieve the basic goal of creating a robust market. As a result, there would be no real cost benefits to California businesses and imposing the requirements could actually result in higher costs to California businesses. Furthermore, this linkage would create a highly specialized market that may well adversely impact the ability to link with other markets in the future. As such, ARB should not enter into a linkage agreement until linkage with other jurisdictions is a realistic option.

One commenter noted that the WCI recently released economic analysis assessing a linked program. This analysis raises concerns that linkage with Québec may fail to create a more robust market. Another commenter noted that, in a report released in the spring of 2012, Québec's acting Auditor General found serious flaws with the integrity of the systems to measure carbon emissions to the point of calling the measurements arbitrary.

Preliminary Agency Response: While deferring linkage with Québec may allow for a broader market in the future when several jurisdictions are ready, it is important to take this first step to develop a regional program to which other jurisdictions can link. The successful linkage of the California and Québec cap-and-trade programs will be a clear signal that California is taking the next step to work with other sub-national jurisdictions to address climate change and increase GHG emission reductions through

cost-effective methods for its covered entities. As discussed above, Québec, as well as many other states and provinces, are simply too small to implement cap-and-trade programs on their own. Therefore, failure to link with Québec in the near-term now may jeopardize future actions to link with other jurisdictions.

Linking with Québec has benefits for the program itself. Linking enlarges the market for compliance instruments, potentially improving liquidity. Linking with Québec also increases the diversity of emission sources. By linking with a jurisdiction that is somewhat distant, the variability of hydropower availability in the Northwest is also counterbalanced to some degree.

As noted in the ISOR, the impact of linking with Québec could cause the allowance price in California to remain unchanged or increase slightly. The economic analysis also shows that by linking with Québec, we expect a net flow of funds into California, enabling more emission reductions to occur in the state. If the flow were in the other direction, with California funds enabling greater emission reductions in Québec, it would also benefit California by enabling emitters to comply at lower cost. Consequently, the economic analysis shows that both jurisdictions benefit by linking regardless of the direction that the allowance price moves by linking.

Relative to the Auditor General's report, ARB staff notes that the aforementioned report relates to Québec's last action plan on climate change and discusses the way Québec evaluates, quantifies, and follows the results of the different programs they have in place since 2006. These programs include, among others, energy efficiency, public transportation, and biotechnologies. The report has no relevance to Québec's mandatory reporting program or Cap-and-Trade Regulation. Relative to the broader assessment, Québec is currently updating its plan and addressing the concerns expressed by the Auditor General.

B. Evaluate Potential Adverse Impacts on California Businesses

There were several comments raising concerns that linkage with Québec could adversely impact California businesses. Generally, commenters noted that the WCI economic analysis suggested that Québec's greenhouse gas emission reductions are expected to be significantly higher than in California. Consequently, the commenters maintain that, while the overall program costs would be less in a linked system, the overall costs to California businesses would be higher due to a disproportionate reliance of Québec on California emission reductions. One commenter took exception to the statement in the ISOR indicating that increasing the price of allowances benefits California businesses because it allows them to invest in more expensive emission reductions that can then be sold to Québec. The exception was based on the long lead times

necessary to complete projects in California and the greater need for compliance instruments in California.

Several commenters also note that the proposed amendments for setting the auction reserve price could unnecessarily penalize the jurisdiction with the weaker currency. The proposed amendments set the auction reserve price considering both the rate of inflation and the exchange rate. The commenters maintain that compliance entities in the jurisdiction with the weaker currency would face higher compliance costs simply because they could be subjected to a higher floor price. In addition, they noted that the price floor could increase significantly in a linked market compared to a California-only market. Thus, commenters recommended that the auction reserve price be set in one currency only, or be set as an average or lower of the respective jurisdiction's auction reserve price instead of the higher of the two auction reserve prices.

Preliminary Agency Response: The economic advantages of linking with other jurisdictions are analogous to the benefits of including multiple sectors under a broad California Cap-and-Trade Program. Expanding the number of sources that are able to trade allowances will reduce the overall cost of achieving the desired level of emission reductions and improve the efficiency of the emissions trading market. In these ways, linking benefits each jurisdiction – the direct result of lower costs of abatement and expanded reduction opportunities.

While the particular effect of linking on the allowance price will depend on factors such as the relative size, cost of reductions, and availability of offsets in the California and Québec markets, the analysis indicates that the impact of linking with Québec could cause the allowance price in California to remain unchanged or increase slightly. Among the potential impacts that staff analyzed is a small increase in revenues flowing into the California economy as a result of regulated entities in Québec seeking to reduce their cost of complying with the Québec program by purchasing California allowances. Fully accounting for the potential in-flow of revenue from Québec resulted in positive impacts to California. Additionally, linking with Québec could lead to greater criteria pollutant and greenhouse gas emissions reductions in California. Overall, staff finds no significant adverse impacts on California businesses or consumers as a whole as a result of the proposed regulation compared with impacts previously presented in the October 2010 analysis of the Cap-and-Trade Regulation.

It is true that choosing the higher of the two auction reserve prices may result in slightly increasing the floor price above what it would be in the absence of linking. However, such an action also ensures that no linked jurisdiction would be selling its allowances below its designated floor price as the result of currency exchange rate fluctuations. This latter benefit outweighs the cost of slightly higher floor prices.

C. Consider a Simpler Approach

Some commenters suggested that a simpler approach to linkage is necessary. In a simpler approach, only two criteria would be needed: (1) a robust mechanism to ensure that a ton is a ton; and (2) a mechanism to accept allowances and offsets from other programs (even with including a limitation on such use by individual emitters). One commenter suggested that California could take a simpler approach by accepting the allowances from a larger and already mature climate change program such as the European Union Emissions Trading System.

Preliminary Agency Response: Through the public process, the Board adopted regulations that set forth the framework for linking its Cap-and-Trade Program to other emissions trading systems of similar scope and rigor. While simplicity would be desirable, such a program would not meet the rigorous requirements for linking established in statute. Staff will undergo a case-by-case analysis of each program as part of a formal rulemaking process. In addition, the Board will need to approve regulatory amendments reflecting the linkage with a particular program before it can take effect.

California cannot accept the European Union Emissions Trading System without linkage and linkage requires a stakeholder and rulemaking process followed by the Governor's review and findings pursuant to SB 1018.

D. Reconsider the Design of the Market

There were several comments that identified flaws with the current market design and that these market design flaws were propagated in the Québec program design. The commenters noted that, as a result, the market design does not adequately mitigate the risk of market power and market abuse. Furthermore, the commenters stated that these design flaws include the holding and purchase limits and allowance allocation approaches. The commenters noted that, while these same concerns exist in a California-only market, they are exacerbated in a linked market and, in a linked market; ARB may not have the latitude to unilaterally modify flawed policies.

Preliminary Agency Response: The concerns regarding market design issues have been raised throughout the rulemaking process⁸, both for the original regulation and the proposed linkage regulation. There are important policy reasons to include these provisions and they are common to both programs. The proposed linkage with Québec is not a valid reason to revisit these provisions.

⁸ Air Resources Board, California's Cap-and-Trade Regulation, Final Statement of Reasons, October 2011.

As the programs are implemented, staff in each jurisdiction will monitor their respective programs and discuss areas of stakeholder concern or areas that may be modified through future regulatory amendments to enhance market efficiency and cost containment. Both jurisdictions are committed to continuing to work closely with each other and their respective stakeholders to ensure a successful regional market program.

E. Redirect Resources to Market Readiness Activities

Several commenters noted that developing the linkage program was diverting resources from critical market readiness tasks, such as auction preparation and modeling, offset protocol development, accreditation of third part offset registries, and addressing program flaws.

Preliminary Agency Response: Staff disagrees that redirecting resources is necessary. These comments were submitted in June of 2012. Since then, ARB has conducted two auctions and launched the program effective January 1, 2013.

VI. TRANSPARENCY AND PROGRAM MONITORING ARE ESSENTIAL

A. Provide Sufficient Time to Review the Québec Regulation

Commenters in June 2012 identified the need for additional time to review the Québec regulations as they were released in draft form in June 2012.

Preliminary Agency Response: No response necessary as sufficient time was made available since the Board deferred action on the linkage regulatory amendments. The Québec regulations were completed in December 2012.

B. Ensure Transparency Throughout the Process

Commenters stressed the importance of transparency throughout the process and cited several examples where improved transparency was necessary. These included fully engaging regulated parties in reviewing and defining what regulatory program elements should be equivalent between the two programs and providing more access to the activities of WCI and WCI, Inc.

Noting that confidentiality is important, commenters also indicated that some public data is necessary to augment external monitoring efforts and discourage market participants from manipulative positions. ARB should solicit input on data publication structures and consult its independent market monitor and market surveillance committee on this issue.

Preliminary Agency Response: ARB staff agrees that transparency is important. ARB has provided public notice and an opportunity for public comment. In 2012, ARB held two public workshops on the proposed linkage amendments. In addition, on March 30, 2012, ARB released draft regulatory amendments describing the proposed changes needed to link with Québec. ARB accepted public comments on the draft proposed amendments until April 13, 2012. In the interim, ARB held another public workshop on April 9, 2012 to discuss the proposed amendments. Throughout the amendment development process, staff has informally met with stakeholders numerous times to discuss both specific components of the proposed amendments and general concepts.

The WCI policy process has been similarly transparent. To date, the WCI has had 138 separate engagements with stakeholders, including 138 documents; 86 stakeholder meetings, webinars, and calls; and has received written comments on 48 occasions. Some engagements included all three of these elements, while some included only one. For more information about WCI stakeholder engagement, please see Appendix B to the staff report, which can be found at:

<http://www.arb.ca.gov/regact/2012/capandtrade12/capandtrade12.htm>.

The decision to form WCI, Inc. followed a comprehensive assessment of options to efficiently provide the support systems needed to facilitate linkage with states and jurisdictions. The establishment of WCI, Inc. is consistent with the model chosen by the Regional Greenhouse Gas Initiative (RGGI) in which several eastern states are participating in a regional cap-and-trade program. More information about WCI, Inc. can be found at <http://www.wci-inc.org/>.

The benefits of participating in WCI, Inc. includes reduced administrative costs through cost sharing with other jurisdictions and enhanced security and effectiveness of program infrastructure across programs, including the tracking system, auction operation, and market monitoring.

As with other voluntary agreements that ARB establishes with local air districts, states, federal government, and contractors, ARB's participation in WCI, Inc., does not confer any decision-making authority, oversight, or enforcement to WCI, Inc. Decisions concerning ARB's Cap-and-Trade Regulation are made by ARB at the direction of the Board, not WCI, Inc.

C. Provide Ongoing Program Monitoring

Several commenters cited the need for the California regulation to contain procedures for tracking the performance of each program and from monitoring

and reporting on the California and Québec markets. In addition, market simulation and monitoring must include both jurisdictions.

Preliminary Agency Response: ARB staff agrees that program monitoring is necessary. ARB takes market monitoring very seriously and staff fully intends to track allowance flows and the trading activities of covered and non-covered entities. The same is true of market performance, which will be continually assessed. The data in the joint market program will be subject to close review by the jurisdictions and the same market monitor. At least annually, staff will provide a Board update on the market program.

Attachment 1

List of Commenters on the Proposed Linkage Regulatory Amendments

Commenter(s)	Written Comment June 2012 45-Day and 15-Day Public Comment Periods	Oral Comment June 28, 2012 Public Hearing	Written Comment January 2013 15-Day Public Comment Period
Pacific Gas & Electric Company	x		x
Southern California Public Power Authority	x	x	x
Southern California Edison	x		x
Gypsum Association	x		
PE-Berkeley, Inc/Olympic Power, LLC (Joint Letter)	x		
Coalition for Emission Reduction Policy	x		
The Wilderness Society	x	x	
Western States Petroleum Association	x	x	x
Chevron	x		x
Valero	x		
Western Power Trading Forum	x		
Independent Energy Producers Association	x		x
Association of Home Appliance Manufacturers	x		
AB 32 Implementation Group	x	x	x
Environmental Defense Fund (EDF)/Natural Resources Defense Council (NRDC) (Joint Letter)	x		
EDF/The Nature Conservancy, NRDC, Center for Resource Solutions (CRS) (Joint Letter)	x		
Center for Biological Diversity (CBD)	x		x
Union of Concerned Scientists (UCS)	x		
Sempra Energy Utilities		x	x
Calpine Corporation			x
UCS/Breathe California/Pacific Forest Trust/CBD (Joint Letter)			x
International Emissions Trading Association			x
EDF/The Nature Conservancy/CRS (Joint Letter)			x
NRDC			x
EDF		x	
Pacific Forest Trust		x	