

California Air Resource Board
International Offsets in a California Cap-and-Trade Program
Comments of Morgan Stanley Capital Group Inc.
September 11, 2009

Morgan Stanley Capital Group Inc. (MSCG) appreciates the opportunity to provide input to the Air Resources Board regarding the use of international offsets in a California-only cap-and-trade program. We did not have a representative attend the public workshop, so our comments are based solely on the material in the slide presentation posted to the web site, and are not informed by any discussion that may have occurred at the public meeting. If there are questions or a desire for follow-up discussion, please contact Steve Huhman, Vice President at (914) 225-1592 or via e-mail at steven.huhman@morganstanley.com.

Question 1: Should ARB accept existing international offsets?

MSCG strongly believes that California should accept all offsets that meet quality criteria, regardless of country of origin or timing of creation. The underlying rationale for utilization of offsets of any geographic or temporal origin is to attain the desired emissions reductions at the lowest possible cost to consumers. A decision to exclude from consideration a class of offsets based solely on place of origin risks raising the cost of greenhouse gas reduction to California consumers and businesses, without any offsetting incremental benefit to the climate. In fact, it is likely that a high percentage of the most cost-effective reduction opportunities will be in less developed economies, as they will, on average, be using the oldest, least efficient technologies. Furthermore, a decision not to accept existing offsets runs counter to the generally accepted principle of not discouraging early action, which a consensus agrees is, all other things being equal, of more benefit to the climate.

Another reason to include existing international offsets is to maximize chances of an adequate supply. It must be remembered that offsets can only be generated where there is no greenhouse gas emissions cap in effect - -that is, from an uncapped economy or an uncapped sector in capped economy¹. If one projects that the US economy is likely to become increasingly covered by caps in the relatively near future, then the US may not prove to be a plentiful source of offset credits for very long. Furthermore, the credits that the US does produce are likely to be heavily concentrated in the controversial forestry and agricultural sectors. These types of credits may or may not end up meeting California's quality criteria. Therefore, a decision to not allow existing international

¹ Some might contend that a Kyoto Protocol Joint Implementation project results in an "offset" created in a country and sector with a cap. Others would say that it does not, since the practical effect is to transfer Assigned Allocation Units (AAUs), that is, allowances, from one country to another, as opposed to creating net additional instruments that can be used for compliance purposes. This semantic debate should not be allowed to distract from the sound underlying point about the source of offset credits

offsets in California's program risks cutting the state off from an adequate quantity of supply.

Question 2: Should ARB accept project-based offsets, accept sectoral crediting only, or a combination of the two?

MSCG does see potential for administrative efficiency improvements in a sectoral approach. However, the concept is still in the early stages of development, and many questions remain unanswered regarding practical implementation issues. Such questions may or may not ultimately get resolved in a manner that makes a sectoral approach workable. This may be especially true in the international arena, where many of the least-developed countries may not have the information infrastructure needed to implement and monitor a sector-by-sector approach. Therefore, given the decision timetable ARB is working under, it does not seem wise to opt for a sectoral approach at the outset of the GHG reduction program.

Practically, the ARB program is almost forced to start life with a project-based approach. It would seem sensible to have periodic re-evaluations of the development of a sectoral approach, perhaps every three years. If and when the sectoral concept becomes fully realized, an evaluation can be made of the desirability of moving to a combined or sectoral-only approach. If it is determined to make a change, then a migration/transition plan can be developed and implemented.

Question 3: How could ARB enforce international offsets?

MSCG does not think it is practical or cost-effective for California to create its own "enforcement" infrastructure to vet individual international offsets. Instead, the state should rely on established bodies with expertise in the area to perform the vetting function. California should focus on analyzing and monitoring the vetting agencies, to ensure that their standards and practices result in the creation and certification of offsets that meet California standards.

We believe that some of the discussion that has taken place that relates to the possibility of California entering into agreements with governments of other countries, or only accepting offsets from countries with a regulatory oversight infrastructure, misunderstands the nature of offsets. In our view, it is highly unlikely that governments will set up administrative infrastructures to oversee offset projects that do not come into existence pursuant to a program mandated by the local government. Offset projects come into existence pursuant to private contracts for purposes of creating something that is of value to the financier, usually of use only in another country (except in countries with GHG emissions caps of some sort, such as the EU). The local government really has no stake in the existence of, quality of, or property rights of the offset, and therefore has no motivation to spend scarce resources managing it. This is especially true in the least developed countries where government resources are the scarcest. It is further true that in many least-developed countries, the quality of government administration is very poor and unreliable. This can be due to lack of resources, lack of training and experience, or even outright systemic corruption. Regardless, reliance on the output of a regulatory infrastructure in such countries, even if it were to exist, would likely not be wise.

Finally, MSCG would like to support the use of the CDM as a project vetting agency. There have been many criticisms of this agency over the past few years, and we would acknowledge the legitimacy of some of them. Many others, we find spurious. The CDM has not turned a deaf ear to its critics, instead working to improve its processes in the spirit of continuous improvement. Any large organization created to spearhead a brand new endeavor from scratch, as the CDM was for offsets, is bound to find imperfections at start-up that will have to be fixed by mid-course corrections. We believe CDM is moving with all deliberate speed to respond to the legitimate criticisms, and should not be dismissed as an offset validating agency. California should not let the “perfect be the enemy of the good” when assessing whether or not it can accept CDM certified offsets for use in the AB32 compliance program.