Tuesday, August 09, 2011

Chairman Mary Nichols and ARB Staff
Air Resources Board, California Environmental Protection Agency
1001 I Street
Sacramento, CA 95812

RE: 15-day changes to Cap and Trade Regulation

Dear Chairman Nichols:

Thank you for the opportunity to comment on the forthcoming cap and trade program under AB32.

New Forests manages approximately $1 billion in institutional capital for investments in sustainable forestry and associated environmental products, such as carbon, biodiversity and water. The company is headquartered in Sydney, Australia, with offices in San Francisco and Singapore. New Forests has been active as a company in forest carbon markets for over five years: New Forests' staff participated in the committee that developed an early version of the CAR forestry protocol, contributed to the Verified Carbon Standard's AFOLU guidelines, contributed to the development of the New South Wales Greenhouse Gas Abatement Scheme, participated in the stakeholder working group that assisted CAR with the development of its proposed aggregation guidelines, and currently participate in the CAR Mexico Forest Project Protocol committee. New Forests' joint venture investment vehicle, the Eco Products Fund, has invested actively in forest carbon projects for the California market, and we are currently investing capital in forest carbon offset projects through a new fund vehicle, Forest Carbon Partners.

We hope that the practical experience in project development and offset project investment that informs our comments and suggestions proves useful to staff as they finalize the regulations for the future offset program. Thank you for considering our comments, which we have attached to this cover letter.

Sincerely,

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Manager, Carbon Investments and Policy
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1. Incorporate Aggregation Rules into the U.S. Forest Projects Protocol

The staff report for the Compliance Offset Protocol for U.S. Forest Projects (the "Compliance Forest Protocol") released with the original Proposed Regulation Order highlighted that ARB staff decided not to include aggregation rules for smaller forest owners in the protocol at that time. ARB staff noted that they recognize the significant potential benefits for the environment and offset supply of lowering barriers to participation for small forest owners.

We are grateful for the focus of ARB staff on the barriers to participation facing smaller forest owners, and we would encourage ARB to incorporate aggregation rules into the compliance Forest Offset Protocol (or establish forest carbon aggregation through a related, separate protocol) in 2011. Approximately 75% of all private forest acreage in the U.S. is held in ownerships of under 5,000 acres. Family forest owners often maintain forests that have higher carbon stocks and older growth stands than industrial forest owners. These older growth forests are at significant risk of harvest and conversion due to financial pressures and estate planning problems faced by the families that own and manage them. At the same time, family forest owners face high upfront costs in developing carbon offset projects and a difficulty in marketing small lots of offsets. Aggregation makes carbon projects feasible for family forest owners by helping them achieve economies of scale while maintaining high standards for carbon measurement and offset quality.

Enabling aggregation will be critical to delivering offset supply from U.S. forests and to ensuring that the carbon markets are not accessible only to large industrial forest owners. In our view, the Aggregation Guidelines adopted by CAR in August 2010 are not in material conflict with any provisions of the compliance U.S. Forest Projects Protocol, and incorporating a version of the CAR aggregation model would level the playing field for family forest owners, help protect older-growth forests managed by families, and provide a significant boost to forest carbon offset supply. We hope that ARB staff will adopt aggregation rules for forest carbon offsets later in 2011 or in early 2012.

2. Consider slight changes to regulatory language related to offset projects on Native American territory

We commend ARB for adding regulatory language that facilitates Native American participation in the offset market. In our conversations with Native American tribes (without speaking for any Tribal government in particular, of course), we have found broad support for the regulatory language in general but universally shared concerns about two provisions in particular:

(a) §95975(l)(1): There is widespread concern about the venue clause specifying the courts of the State of California. Tribes are accustomed to litigating in U.S. Federal Court, and there may be more comfort with the system if this venue clause was changed to U.S. Federal Court.

(b) §95975(l)(3): There seems to be common agreement that this section may be drafted too broadly; there is no consensus about the situations in which federal government (BIA) approval may be necessary for projects located on Indian lands, and in many circumstances the BIA may not yet have a policy formulated for whether approval is necessary. In essence, the question here is whether the project activity has been properly permitted, and we would urge ARB to treat this like any other governmental permit – simply require it "if applicable" and accept it in the form suitable to the permitting agency. We would therefore recommend §95975(l)(3) to be redrafted to read "<u>if necessary under applicable law and policy</u> the Tribe must also provide

ARB with proof of federal approval of the Tribe's participation in the requirements of the Cap-and-Trade program, in a form provided by the approving federal agency."

3. The definition of Forest Owner is too broadly drafted

In the current draft, ARB defines "Forest Owner" as "the owner of any interest in the property involved in an offset project", including a conservation easement. As drafted, this definition would include someone who owns a road right of way on another's property, or a conservation easement that simply prevents residential or commercial development but has no impact on forest management. These individuals or organizations with no ability to control forest management would, in this draft language, effectively be jointly and severally liable for any liability that accrues under the offset system through the actions of the individual or entity that does effectively control the management of the trees. This doesn't make sense: person A should not face a contingent financial liability due to their driveway crossing person B's property and therefore holding a right of way easement.

We would recommend defining Forest Owner to include only the fee holder and any timber right holder, if applicable. If the fee and timber rights are not separated, the fee holder is clearly the Forest Owner and liable under the offset project rules; if the fee and timber rights are separated, both would be the Forest Owner and effectively the fee and timber rights holder would be jointly and severally liable (and the system should therefore look for approval of both interest holders in establishing a project). Conservation easement holders should only be considered Forest Owners *if* the easement is a "working forest conservation easement" where the easement holder has the right to affect the management of the trees on the property; a viewshed or anti-development conservation easement holder should not be considered a Forest Owner.

4. §95983: Forestry Offset Reversals.

We support the changes made to this section and think that the amendments offer substantially increased clarity on how intentional and unintentional reversals of forest carbon will be handled by the cap and trade system.

However, we urge ARB to allow for at least five months for replacement of offset credits with other compliance instruments in all circumstances. It could prove very difficult for a market participant to acquire the necessary compliance instruments in 90 days, particularly if the market is illiquid at any given time.

5. §95985: Invalidation of ARB offset credits.

We understand the concerns of ARB staff that led to the inclusion of this section; however, we believe that this section, as drafted, will render the offset market simply unworkable for many potential participants.

(a) We recommend that ARB consider using a buffer mechanism to manage this risk.

ARB should certainly invalidate offset credits if material misstatements, mistakes or fraud are discovered for a certain period after issuance. Assigning liability for replacement of those invalidated offset credits to the buyer or any entity within the supply chain, however, would drive market participants to attempt to create chains of indemnity. We have yet to meet a Forest Owner who would accept a long tail of liability (at a very uncertain

carbon price) due to mistakes or fraud by other professionals in the supply chain over which he or she has no control. Thus, if the Forest Owner is liable for replacement, they will seek indemnifications from the project developer or forestry consultants, who would in turn seek indemnification from the third-party verifier, and perhaps even the registry entity (which could conceivably, after all, create material inaccuracies in offset issuance through poor administration or data quality). However, indemnifications are only as good as the credit of the entity offering the indemnification – you cannot collect from a thinly capitalized or perhaps insolvent entity, for example. Most Forest Owners would therefore seek to require that any companies or individuals involved in project development not only indemnify the forest owner for professional errors, but also carry insurance. However, no insurance company currently offers errors and omissions insurance that would pay out the cost of credit replacement if there is a claim, as it is very difficult at this time to assess both the frequency of claims and the value of the claims given the absence of price history in the market. In the absence of a proper insurance product, which is very unlikely to be developed in the early years of the system, and which would be very expensive if it is developed, most potential offset producers would elect to not participate in the market because the relative risk of liability and the magnitude of that liability would be almost impossible to assess without years of market data . . . and yet years of market data will not develop if few participants enter the market.

We therefore strongly suggest that ARB reconsider the alternative mechanism of addressing valid concerns over material mistakes or fraud in offset production: an ex-ante deduction and buffer reserve. ARB could address this problem by requiring offset project registries to offer errors and omissions insurance that covers claims under ARB offset invalidation "in kind", i.e. in compliance instruments rather than in financial payments adequate to acquire a certain volume of compliance instruments. However, we doubt that offset registries will be able to effectively offer this insurance, as they would have to be re-insured by one of the major re-insurers, and we doubt that any of the major insurers would take that risk at a price accessible to registries that are currently thinly capitalized organizations. We therefore strongly recommend the ex-ante deduction and buffer reserve method (operated by ARB) for addressing this issue.

Such an ex-ante buffer reserve should not, in principle, be time-consuming or costly to operate. After all, ARB is already planning to operate a similar reserve (the buffer reserve for forest carbon offsets) to address other types of post-issuance risk (in that case, primarily unintentional reversals). The mechanics of operating a buffer account do not differ at all between different types of buffer accounts; only the root cause of credit invalidation varies. ARB may feel that it is difficult to assess the likely rate of invalidation and therefore the appropriate rate of pre-issuance deduction to divert into a buffer reserve to cover credit invalidation due to material mistakes or fraud. If so, ARB has the option of simply setting the deduction at a very conservative rate and applying adaptive management as data comes in. If the ex-ante deduction was too high and very few credits are being invalidated, ARB could reduce the deduction in future vintage years. If the ex-ante deduction was too low and more credits were invalidated than were retained by the buffer reserve, ARB could increase the deduction in future vintage years *and ensure climate integrity by reducing the cap by an appropriate amount.*

In summary, ARB is in a superior position to manage this risk using adaptive management over time and at a low cost compared to market participants, while maintaining climate integrity.

(b) We recommend that ARB further refine the conditions in which credits are invalidated.

Wherever there is measurement, there is error in measurement. No measurement is completely precise. We can therefore expect offset project data reports to yield credit estimates that are higher and lower than the actual, true value. It is necessary and appropriate to invalidate credits when such errors (or outright fraud) is discovered. However, it makes no practical or climatic sense for ARB to invalidate all offset credits from an offset project data report due to any error that renders the report not "true, accurate or complete" in any way.

ARB should strike §95985(b)(1), the other provisions in this subsection address both fraud and significant errors, and this catch-all provision is likely unnecessary. However, if ARB retains §95985(b)(1), ARB should add a materiality qualifier so that offset project data reports are not invalidated due to immaterial errors that have no significant effect on offset credit issuance – e.g. "materially true, accurate or complete".

Finally, ARB should only invalidate those credits that are in excess of the actual value. If a second verifier discovers a material mistake that led to an overstatement of offset issuance by 10%, then 10% of the total issuance to that offset project data report should be retired from the buffer reserve. Invalidating all offset credits under an offset project data report is not necessary for any climatic reason; it is only practically necessary if ARB is seeking to recover the invalidated offsets from participants *ex post*. If ARB adopts the buffer reserve approach, it could invalidate the appropriate amount while continuing to recognize valid emissions reductions or avoided emissions.

Thank you for your time in considering our comments.

Sincerely,

New Forests