



August 11, 2011

California Air Resources Board
1001 I Street
Sacramento, California 95812

Subject: Comments on the offset provisions of the Proposed 15-Day Modifications to the Regulation to Implement the California Cap-and-Trade Program (released July 25, 2011)

I. Introduction

These comments are submitted by the Offsets Working Group (OWG), a collaborative team of publicly-owned electric utilities serving customers in California.¹ Each of the OWG members is a Covered entity that will have a Compliance obligation under the Air Resources Board's (ARB) proposed regulations. These comments serve as the OWG's responsive input to the provisions of the Proposed 15-Day Modifications related to offsets.

II. OWG Recommendations

A. Recommendation on Section 95854 – The offset quantitative usage limit should be applied to the full duration of the proposed cap-and-trade program.

The OWG both acknowledges and appreciates ARB's improvement of Section 95854 by removing the applicability of the 8% quantification usage limitation to the annual compliance obligation. As the OWG considered this improvement, however, it came to light that the availability of offsets may not necessarily follow an artificial schedule based on calendar years. It's probable that the limited supply of offsets will become available in a lumpy manner, with greater amounts being available in the later compliance periods as forestry projects progressively sequester greater amounts of carbon and as additional protocols are added. This could lead to a scarcity of offsets in the earlier compliance periods and an unusable abundance in the later compliance periods.

¹ The OWG includes representatives from the Modesto Irrigation District, Redding Electric Utility, City of Roseville, Sacramento Municipal Utility District, and Turlock Irrigation District. These utilities comprise approximately 1/3 of the electricity load in California served by publicly-owned electric utilities.

Also, the three-year limitation may place verification restrictions on Offset Project Operators (OPOs), forcing them to verify at times strictly by the calendar year. This may not be optimal or cost-effective for reducing emissions. A case in point is when variations in the reductions achieved by a forestry project may be out of sync with the strict 3-year compliance periods. Although a forestry offset project is only required in the Regulation to verify its carbon sequestration every 6 years, the project would need to, in fact, verify every 3 years in order to coordinate with the Covered entities' triennial compliance obligations. This would result in higher costs to the project developer with no additional benefit to sequestering additional emissions by the project.

In order to overcome these artificially imposed problems and ensure that Covered entities have full access to an ample supply of offsets, ARB should modify the quantitative usage limitation to a running 8% of each Covered Entity's total compliance obligation. The OWG supports amendments to Section 95854 as follows:²

- (b) The total number of compliance instruments identified in section 95854(a) that each covered entity may surrender to fulfill the entity's compliance obligation ~~for a compliance period~~ must conform to the following limit:

O_0/S must be less than or equal to L_0

In which:

O_0 = Total number of compliance instruments identified in section 95854(a) submitted since January 1, 2013 to fulfill the entity's total compliance obligation ~~for the compliance period~~ through the current compliance year.

S = Covered entity's total compliance obligation beginning January 1, 2013 through the current compliance year.

B. Recommendation on Section 95973(a)(2) – The regulations should have greater clarity regarding the requirements for early action projects.

The OWG recommends greater clarity³ in this Section by removing the second sentence in Section 95973(a)(2) from that paragraph. As it stands, the sentence implies that the items in (A) through (C) are for Early Action Offset Protocols, rather than Compliance Offset Protocols as intended. In addition to the deletion in 95973(a)(2), the core component of the sentence should be re-inserted into Section 95973(c) as follows:

- (a)(2) Meets the following additionality requirements, as well as any additionality requirements in the applicable Compliance Offset Protocol, as of the date of

² This proposed language was presented to the OWG in draft comments prepared by the Pacific Gas & Electric Company.

³ Cal. Gov't Code § 11349.1(a)(3). "Clarity" means written or displayed so that the meaning of regulations will be easily understood by those persons directly affected by them." Cal. Gov't Code § 11349(c).

Offset Project Commencement. Early action offset projects which transition to the compliance offset program pursuant to section 95990(k) must meet the requirements of that section:

...

- (c) Early Action Offset Project Commencement Date. Offset projects that transition to Compliance Offset Protocols pursuant to section 95990(k) must meet the requirements of that section. These projects may have an Offset Project Commencement date before December 31, 2006.

C. Recommendation on Section 95981.1 – The regulations should establish a maximum timeline for project review by ARB.

The ARB process has a timeline for offset credit issuance that defines the timelines for ARB’s intermediate steps and the resultant credit issuance. The starting point, however, is not fixed in time. The regulations should set the timeline for ARB to begin its review of Verification Statements submitted for approval. This will create more certainty for OPOs and serve as a guideline for their data submissions to ARB. In addition, a maximum timeline will benefit Covered entities that are considering the purchase of offset credits near the end of a compliance period. The OWG supports an addition to Section 95981.1 as follows:

Section 95981.1. Process for Issuance of ARB Offset Credits

- (a) ARB will review the Positive Offset or Qualified Positive Offset Verification Statement within 30 calendar days after submission to ARB by an Offset Project Registry, Offset Project Operator, Authorized Project Designee, or any other third party authorized by the Offset Project Operator.

D. Recommendation on Section 95985 – ARB should establish a compliance buffer pool that will be used to replace surrendered offset credits which have been invalidated.

The OWG supports the use of offsets, within the limit established by ARB’s regulations, as an effective cost containment tool for the cap and trade program. However, the OWG is concerned that there will be insufficient supply of offsets, and specifically in this context that ARB’s current approach to invalidation will both constrain the supply and increase the costs of offsets. The OWG believes that it will not be easy or cost-effective to insure the risk of offset invalidations through traditional insurance markets. Nor does the OWG believe that including language in contracts that will pass the risk from the buyer to the original developer (or someone up the contract chain) will work well, as indications from the market is that many offset project developers will not entertain such clauses. Some counterparties may not be willing to enter contracts obligating an entity other than the buyer, and OPOs are in the best position to understand whether particular offset credits have a risk of invalidation.

Instead of placing a strict liability on buyers, the OWG recommends that ARB establish a Compliance Buffer Pool (CBP) that is separate but similar to ARB's Forest Buffer Pool. The CBP would be filled with a fraction of all offset credits *surrendered* to ARB for compliance. ARB could use a risk factor for each type of offset project. For example, the OWG expects that the chance of invalidation for ODS and livestock methane projects is slight. Therefore, ARB could begin filling its CBP with a very low percentage of credits from each lot that is surrendered, possibly 0.5%. This would create a minimal impact on the price of offsets, and yet achieve significantly more certainty for buyers as a whole.

If ARB does establish a CBP, the OWG recommends that the regulations include a review by ARB after the first triennial compliance period. Pursuant to this review, ARB could then determine whether the 0.5% (as used in the OWG's example) was too high, too low, or sufficient to cover the invalidations actually observed during that time period.

E. Recommendation on Section 95985(b)(2) - The regulations should have greater clarity regarding the invalidation of offset credits.

Section 95985(b)(2) should be drafted with greater clarity⁴ to ensure its consistency⁵ with AB 32 and the proposed regulations as a whole. The regulations should unequivocally state that a finding of greater than a 5% overstatement in a project will not result in the invalidation of *all* offset credits from that project. The regulations should clearly state that only the overstated amounts are subject to invalidation. ARB must remain true to the regulatory principle that serialized offset credits representing real, additional, permanent, quantified, and verified emission reductions are valid. Each serialized offset credit should stand on its own. In sum, ARB has no authority⁶ to invalidate registered offset credits that are in full compliance with the regulations.

F. Recommendation on Section 95972(b) and ARB Forest Offset Protocol Section 3.3 – ARB should increase the crediting period for reforestation projects to no less than 50 years.

The OWG repeats its request for extending the crediting period for forestry projects. Firstly, forestry projects are required to exist for at least 100 years and a 10-30 year crediting period establishes an arbitrary limitation. Secondly, a typical reforestation project will produce the majority of its emission reductions in the second half of its 100-year project term. Forest project operators should be given greater certainty than provided by a 10-30 year crediting period. They are already required to file annual reports to ARB and be verified no later than every 6 years. With these limitations, it's not as if a reforestation project could operate "under the radar" if the crediting period were extended to 50 years. The OWG refers ARB back to the data on the

⁴ Cal. Gov't Code §§ 11349.1(a)(3), 11349(c).

⁵ Cal. Gov't Code § 11349.1(a)(4). "Consistency" means being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law." Cal. Gov't Code § 11349(d).

⁶ Cal. Gov't Code § 11349.1(a)(2). "Authority" means the provision of law which permits or obligates the agency to adopt, amend, or repeal a regulation." Cal. Gov't Code § 11349(b).

Cuyamaca Rancho State Park reforestation project that was entered into ARB's official record by the OWG's comments on the 45-Day language. The OWG believes that the data provides substantial evidence for increasing the crediting period to 50 years.

G. Recommendation on Section 95976(e)(2) – The record retention requirements should not be overly burdensome.

The OWG agrees with ARB's change to the records retention requirement which was reduced to 15 years from the previous 100-year requirement. The longer requirement was unreasonable and unnecessarily burdensome and the OWG appreciates ARB's recognition of this. However, in light of ARB's 8-year statute of limitations for invalidating offset credits, the OWG requests ARB to explain the necessity⁷ for having a retention requirement that is longer than the relevant statute of limitations.

H. Recommendation on Section 95990 – ARB should conduct stakeholder workshops to explain the process for registering early action offset credits and transitioning early action offset projects.

The OWG is highly supportive of ARB's inclusion of early action offsets within the cap-and-trade program. In order for projects to qualify for early action credit, the OPO must carefully follow the proper steps for listing, verification, issuance, and registration. The regulations also have requirements for transitioning early action offset projects into ARB offset projects. The OWG requests ARB to hold at least one stakeholder workshop to explain the entire process in a clear and concise manner. This workshop should be held very soon as OPO's are already contemplating structuring their projects to produce these early action offset credits. If the record is re-opened for a second round of 15-Day comments, the workshop should be held in advance of this period.

I. An AQMD should not act as a verifier.

After substantial contemplation of the this issue by the OWG, the OWG expresses its concern surrounding the true opportunity for conflict of interest issues to arise by including an Air Quality Management District (AQMD) as an offset verifier. Since the AQMD's are essentially governed by ARB, it is impossible to assume that their role could be completely separated from ARB's role as the primary regulator of the entire cap-and-trade program. In addition, many of the Covered entities, including all members of the OWG, hold title to air permits issued and overseen by their regional AQMD's. There is no certainty in the regulations to prevent an AQMD from holding such an air quality permit to an additional standard above the current state requirements by requiring the Covered entity to purchase additional offsets beyond what is allowed under the cap-and-trade program. Further, the role of offset verification is out of the

⁷ Cal. Gov't Code § 11349.1(a)(1). “‘Necessity’ means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute” Cal. Gov't Code § 11349(a).

scope of the AQMD's regulatory authority. Exercising this role seems to create a conflict through the unauthorized use of taxpayer funds.

J. Additional Offset Protocols.

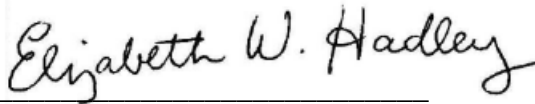
The OWG is concerned that with just four approved compliance offset protocols and the opportunity for some Early Action Offsets there will still not be adequate supply of offsets in the market, particularly in the early years. The OWG, therefore, urges ARB to expeditiously consider and adopt new compliance offset protocols. The OWG believes that a variety of protocols that have been developed in the market can be fairly quickly adopted as compliance protocols.

III. Conclusion

The OWG thanks ARB for evaluating and considering the foregoing comments.



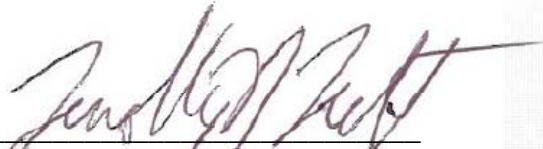
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