BEFORE THE
AIR RESOURCES BOARD
OF THE
STATE OF CALIFORNIA

SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY COMMENT ON PROPOSED OFFSETS PROGRAM IN THE CAP AND TRADE REGULATION

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SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY COMMENT ON PROPOSED OFFSETS PROGRAM IN THE CAP AND TRADE REGULATION

I. INTRODUCTION AND SUMMARY

The Southern California Public Power Authority ("SCPPA") [1] respectfully submits this comment on the offsets program established in the proposed regulation entitled *California Cap on Greenhouse Gas Emissions and Market-based Compliance Mechanism* ("Cap and Trade Regulation") released on October 28, 2010. Offsets are a key part of the proposed cap and trade program.

SCPPA has separately provided comments on other aspects of the Cap and Trade Regulation and on the revisions to the Regulation for the Mandatory Reporting of Greenhouse Gas Emissions ("MRR").

SCPPA's chief concern is that the ARB's approach to the offsets program – both its own protocols and links to other offset programs – is so restrictive and will be finalized so late that not enough offsets will be available at the start of the cap and trade program to contain compliance costs. The ARB's own projections indicate that in some scenarios the demand for offsets will significantly exceed supply. The ARB should make every effort to avoid this outcome, given the key role of offsets in cost containment as repeatedly confirmed in the economic analyses of the cap and trade program. High-quality offset programs currently exist, including the Climate Action Reserve ("CAR") and the Clean Development Mechanism under the Kyoto Protocol ("CDM"). These up-and-running programs should be utilized more fully.

[1] SCPPA is a joint powers authority. The members are Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, Los Angeles Department of Water and Power, Imperial Irrigation District, Pasadena, Riverside, and Vernon. This comment is sponsored by Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, the Imperial Irrigation District, Pasadena, and Riverside.

In its own offset program, the ARB should prioritize the development of offset protocols that can be developed and implemented rapidly in sectors where there is potential for considerable emission reductions at relatively low prices.

In summary, SCPPA raises the following points to help ensure the ARB's offset protocols and links to other offset programs provide ample cost-effective emission reduction options:

- The offset market will be weakened if buyers have primary liability for invalid offsets and cannot rely on the integrity of verified offsets. Placing liability on the verifier would be a straightforward and effective alternative to buyer liability. The ARB has the jurisdiction to do this.
- The ARB's offset supply forecasts indicate a heavy reliance on one protocol – the destruction of ozone-depleting substances ("ODS") – to provide the needed offsets. The ARB should prioritize the development of additional protocols that are likely to result in significant numbers of offsets.
- Baselines should be established with reference to the laws and regulations that apply in the jurisdiction in which the offset project is located. The highest WCI standards should not be used to set baselines. That would be inappropriate and would substantially reduce the number of viable offset projects.
- The initial four ARB offset protocols should not be restricted to U.S. projects only. Projects across North America should be allowed.
- The types of "early action" offsets allowed to be used for compliance should be expanded to include all CAR offsets (Climate Reserve Tons or "CRTs").

- Linking to the CDM and other rigorous offset programs should be considered in 2011. The CDM constitutes the largest, best developed, most liquid, and most scrutinized offset program in the world. It will be an invaluable source of supply, particularly in the early years of the cap and trade program when offsets from ARB protocols and from avoided deforestation ("Reducing Emissions from Deforestation and forest Degradation" or "REDD") are unlikely to be available in any quantity.

II. POTENTIAL SHORTAGE OF OFFSETS SHOULD BE ADDRESSED.

Appendix G to the Initial Statement of Reasons ("ISOR") for the Cap and Trade Regulation notes (at G-16) that "if an allowance reserve of 100 million metric tons is created, at a 2020 allowance price of $25 the demand for offsets may exceed supply by 54 percent under the Appendix N supply assumptions." Table G-2 in ISOR Appendix G indicates that if the allowance reserve is 150 million metric tons, at a $25 allowance price the demand for offsets will exceed supply by 91 percent (under the Appendix N offset supply assumptions). Although offset supply is uncertain, Appendix G notes (at G-15) that the "restrictive" supply assumptions in Appendix N are likely to be indicative of conditions during the early years of the cap and trade program.

Considering these projections in light of the fact that the allowance reserve will be approximately 123 million metric tons, it appears likely that the demand for offsets will be significantly greater than the supply. Without a sufficient supply of offsets, the allowance reserve will not be able to control allowance prices. Considering that allowances are withdrawn from the allowance budget to be put into the reserve, allowance prices, and hence compliance costs, may increase if there are insufficient offsets. *See* Appendix G at G-12.

The Cap and Trade Regulation currently allows only limited types of offsets to be used for compliance, and there are supply concerns for each type, as summarized in the following table.

Offset type	Supply concerns
Offsets issued by the ARB under ARB protocols	Only four protocols will be submitted for approval this year, and only one of those (ODS) has the potential to provide substantial volumes of offsets. Each protocol will be limited to projects within the US. It will take some time before offset projects are developed and implemented using these new protocols.
Certain types of CRTs issued by CAR, as "early action" offsets	Only four CAR protocols (and only specific versions of those protocols) can generate early action offsets. There are limited numbers of CRTs issued under these protocols.
Offsets from cap and trade programs linked to the California cap and trade program	Linking to another cap and trade program will increase the demand for offsets as well as the supply.
Sector-based offsets, e.g., REDD	Sector-based offset programs are at an early stage of development internationally. It is likely to be several years before significant numbers of sector-based offsets are available.

The risks associated with an insufficient supply of offsets should be addressed by accepting offsets from existing offset programs, such as CAR and CDM, adopting more ARB offset protocols, and broadening the application of the ARB protocols. These issues are discussed in more detail below.

III. SUBARTICLE 13: OFFSET CREDITS ISSUED BY ARB

A. ARB offset protocols should not be restricted to projects in the US.

The ISOR notes (at III-10) that the initial ARB offset protocols being proposed are applicable to offset projects in the United States and its territories only, with potential for expansion to Canada and Mexico at a later stage. Given the urgent need for an early supply of offsets, the ARB protocols should cover the US, Canada, and Mexico from the start of the cap and trade program if the necessary technical data is available for each country.

B. Additional protocols should be developed to increase offset supply.

Section 95973(a)(2)(C) (p. A-113) lists the four offset protocols currently proposed for ARB approval. Based on ARB forecasts presented at the offsets workshop on June 22, 2010, the only one of these protocols that is expected to deliver a substantial number of offsets is the ODS protocol. In the first compliance period, 2012-2014, approximately 91 percent of all ARB offsets are predicted to come from the ODS protocol. One protocol, urban forestry, is not predicted to provide any offsets. If any offsets were generated under the urban forestry protocol, they are forecast to cost $100 each.

It is risky to rely so heavily on one protocol, particularly when only a few offset providers are engaged in ODS destruction projects. If the ODS protocol does not provide as many offsets as predicted, there will be a significant shortage of offsets.

The ISOR indicates (at III-5) that ARB staff will periodically propose additional offset protocols. SCPPA encourages the staff to determine which additional protocols are likely to provide the greatest supply of offsets within a relatively brief timeframe and to publish this list of priority protocols together with an indicative timeline for developing these protocols and having them approved by the ARB. These protocols should be finalized as soon as possible to allow

project developers to establish projects, generate emission reductions, and earn offsets for sale in time for the start of the cap and trade program. Having a greater number of offset protocols available will reduce the risk of an offset shortage.

C. Set baselines according to applicable law and practice.

The ISOR states (at III-11):

> Staff's intent in approving protocols is that the standard for additionality will be set to reflect the most stringent regulatory or legal requirements among linked WCI partners.

Setting baselines to reflect the most stringent WCI requirements is not appropriate. Instead, baselines should be set with reference to the regulatory and legal requirements applying in the jurisdiction in which the offset project takes place. This is the approach that appears to be implemented in the Cap and Trade Regulation. Section 95973(a)(2)(A) (p.A-113) sets the following additionality requirements:

> The GHG emission reduction … is not required by law, regulation, or any legally binding mandate **applicable in the project's jurisdiction**, or any GHG reduction or GHG removal enhancement activities that would otherwise occur in a conservative business-as-usual scenario. [Emphasis added.]

Section IX of the ISOR (at IX-121) confirms that:

> The laws and regulations applicable where the offset project is located will determine whether the project is additional.

SCPPA supports this approach for the following reasons.

1. *Applying the highest WCI regulatory requirements to all offset project baselines may substantially reduce offset volumes.*

Applying the most stringent WCI requirements to all offset project baselines would be likely to substantially reduce the number of possible offset projects and the supply of offsets.

Furthermore, even if an offset project is still theoretically possible with the higher standards, it may not be economically viable. If the baseline is required to be set much higher than local regulations would require, relatively few offsets could be generated, and the revenue from their sale would be unlikely to cover the extra costs of meeting the higher standards. In this case, the project would not proceed, and the supply of offsets would be further diminished.

2. *Using jurisdiction-specific standards will not be a disincentive for that jurisdiction to shift towards more stringent standards.*

One reason for using the highest WCI regulatory standards to set baselines may be the belief that doing so avoids "rewarding" jurisdictions for setting low standards and avoids the perverse incentive not to set higher standards. *See* ISOR, p. III-11. However, this view is not supported in practice.

Setting baselines according to local rules and practice does not remove the incentive for industries in a jurisdiction to increase their performance. If offset projects are allowed with a local baseline, and many projects are implemented in a particular sector in a particular jurisdiction, over time the "business as usual" standards of common practice change because the emission reductions activities will become common, and the baseline will automatically become more stringent. A new project in that jurisdiction will have to show that it exceeds the new baseline in order to earn offsets. In this way standards to earn offsets become more stringent over time, independently of regulation.

On the other hand, if baselines are set using the highest WCI standards, few offset projects may be viable, there is no guarantee that local laws will become more stringent, and local industry standards may not change.

The concern with "rewarding" countries for less stringent regulation has been raised in relation to the CDM. China and India both have large numbers of CDM projects, where offsets

are issued for exceeding project-specific (i.e., local) baselines. However, this has not deterred each of those countries from enacting various emission-reduction laws and setting ambitious national and regional targets, for example, in relation to renewable energy and energy efficiency. China's success in developing its renewable energy industry is an example to many countries.

Countries, states, and provinces have many reasons for enacting (or not enacting) more stringent environmental regulations and pursuing clean-energy goals. Whether or not a jurisdiction takes these steps has little to do with whether some entities in that jurisdiction may be able to earn offsets for particular activities.

Therefore there is no reason to set baselines according to the highest WCI standards rather than local regulations.

D. Requiring records to be retained for 100 years is impractical.

Section 95976(e)(2) (p. A-122) requires documents for sequestration projects to be retained for 100 years after the end of the crediting period (which itself may be extremely long). While the reversible nature of sequestration offset projects raises particular issues, requiring a project entity to retain documents for 100 years after it receives the last financial reward from an offset project is unenforceable and verges on the ridiculous. A central record repository should be established rather than imposing the record retention requirement on each individual project developer, few of which are likely to be in existence 100 years after the end of the forestry project crediting period.

E. Offset verification provisions should be split into smaller sections.

Section 95977 (p. A-124 to 144) on "Verification of GHG Emission Reductions or GHG Removal Enhancements from Offset Projects" is 21 pages long, making it by far the longest section in the Cap and Trade Regulation. The sub-sub-sub-divisions in this section give rise to

long cross-references such as to section 95977(e)(2)(C)(iv)(b.)(vi) (p. A-130), which are difficult to locate. For ease of reading it would be preferable to split section 95977 into several separate sections. If necessary, this could be done using a decimal place in the way the sections on biofuel emissions are split: sections 95852, 95852.1, and 95852.2.

F. Record retention and production periods should be changed.

Section 95977(e)(2)(C)(xi) (p. A-133) requires verifiers to retain sampling plans for 10 years and to produce them within 10 days upon request.

As SCPPA has noted in its comments on other sections of the Cap and Trade Regulation, a 10-year retention period is unreasonably long. By contrast, the US Environmental Protection Agency's Mandatory Reporting of Greenhouse Gases Rule ("EPA Rule"), 40 CFR Part 98, only requires records to be kept for three years. EPA Rule, section 98.3(g).

A 10-day period to produce records is too short, given that not all of those days will be working days. Other sections of the Cap and Trade Regulation such as section 95850(b) provide an entity 20 days to produce records upon request. A 20-day period is more reasonable, and should be adopted in section 95977(e)(2)(C)(xi) rather than a 10-day period.

G. Verifiers, not buyers, should be liable for invalid offsets.

Section 95985(d) (p. A-160) requires that an entity that retires or uses an offset (other than a forestry offset) that is later found to be invalid must replace that offset. This approach is often called "buyer liability," although that phrase is not quite accurate insofar as an offset may pass through several buyers before a covered entity surrenders it.

The ISOR (at IX-164) provides two reasons for adopting the "buyer liability" approach:

- It ensures that purchasers and users of offset credits do their due diligence in seeking out high-quality offsets.

- The ARB has clear enforcement authority over covered entities that will be using ARB offsets for compliance.

The first point is one of the reasons why buyer liability is problematic. The second point is not persuasive because the ARB also has enforcement authority over verifiers. Verifiers of offsets rather than the entities that surrender offsets should be held liable for invalid offsets. These issues are discussed in more detail below.

1. *Buyer liability would hamper the development of a liquid offset market.*

The buyer liability approach would hamper the development of a liquid offset market. A key principle of risk allocation is that risks should be allocated to the entity best able to manage those risks. The end user of an offset is not the entity best positioned to ensure that the offset is valid. Compliance entities are likely to buy bundles of offsets from a wide variety of projects through an intermediary to spread their risk, given that any one offset project may not perform to expectations. Few compliance entities would be likely to have the expertise to develop their own offset projects or to negotiate directly with offset developers. It is unrealistic to expect a covered entity to examine each project from which its offsets originate, and it is not appropriate to impose liability on an entity with little ability to ensure the validity of the offset.

Once an emission reduction has been verified and the offset has been issued, the purchaser should be able to rely on the validity of the offset. The verification process set out in such detail in section 95977 is the appropriate way to ensure that offsets are valid. Project inspections by any number of inexperienced offset buyers are unlikely to add any additional certainty to the process but will inevitably increase the costs of offset transactions.

If an offset that a purchaser has bought in good faith may be cancelled at any time, even after it has been surrendered, offsets will become less fungible and the offset market will become less liquid. The risk profile and hence the value of an offset will differ depending on the strength

of the liability provisions in the chain of contracts under which the offset is transacted. This is not an ideal outcome.

2. *Verifiers should be required to replace invalid offsets.*

All emission reductions from projects using ARB offset protocols must be verified by an ARB-accredited verifier in accordance with section 95977 (p. A-124). Detailed provisions for verifier accreditation are set out in section 95132 of the revised MRR. Section 96010(d) (p. A-179) establishes that verifiers are subject to the jurisdiction of the State of California. Therefore the ARB would have clear enforcement authority over verifiers that incorrectly verify an offset that is later found to be invalid, and the ARB could require verifiers to replace invalid offsets.

Imposing liability on the verifier for the validity of the offsets it verifies is appropriate and efficient. In contrast with the offset buyer, the verifier is in the best position and will have the requisite experience to examine the offset project and the emission reductions it generates. Such an approach will lead to reduced transaction costs and increased certainty and liquidity in the offset market.

The benefits of the verifier liability approach have been recognized by the CDM, which requires a verifier to provide replacement offsets if its verification reports are found to be deficient.

In addition, the ARB may wish to consider a buffer pool approach for long-term liability for non-sequestration projects to address the risk that the at-fault entity is no longer in existence when the offsets are found to be invalid.

IV. SUBARTICLE 14: RECOGNITION OF COMPLIANCE INSTRUMENTS FROM OTHER PROGRAMS

A. Clarify provisions on third party offset programs.

Section 95990 (p. A-171) refers to approved third-party offset programs. It is not clear how these programs differ from Offset Project Registries discussed in section 95986. (Section 95990(c) refers to section 95986(d), but this cross-reference does not appear to be correct.)

Presumably CAR is expected to become both an Offset Project Registry and an approved third party offset program. Since the early action offsets can only come from projects using CAR protocols, section 95990(b)(5), it is unclear that there are any other entities that are expected to qualify as third-party offset programs.

B. Allow all types of CRTs to be used for compliance.

Early action is recognized under section 95990 by allowing entities to use for compliance with the cap and trade program offsets issued under four CAR protocols. While this is helpful, the number of CRTs generated under those four protocols is limited.

Arguably this modest approach to early action credits is not sufficient to satisfy the AB 32 requirement to encourage and give credit for early emission-reduction activities (HSC § 38562(b)).

Rather than allowing only a restricted set of CRTs to be used for compliance as early action credits, the ARB should allow broader use of CRTs. CAR offset project protocols are widely respected. They were developed by experts through a public process with input from many organizations including the ARB itself, and they are based on criteria that the emission reductions be additional, real, permanent, and verifiable. There is no reason not to allow a broader use of CRTs on an ongoing basis as well as to recognize early action.

CRTs from any version of any finalized CAR protocol and from projects anywhere in North America should be able to be used for compliance with the cap and trade program (subject to the offset limit), at least in the first compliance period when few ARB-issued offsets would be available.

This approach would satisfy AB 32 requirements to recognize early action. It would also help ensure a much-needed supply of offsets early in the cap and trade program.

C. The re-verification requirements for early action offsets are excessive.

Section 95990(f) (p. A-174) details the verification process that is required for early action offsets. In relation to this section, the ISOR states (at IX-176) that the verification services are provided for the project as a whole rather than separately for each vintage year of credits. However, this is not evident from the regulation, section 95990(f)(3), which refers to verification for each year in which the offsets are issued. The ISOR (at IX-176) also refers to the ability of buyers of early action offsets from a project to group together and obtain one verification rather than separate verifications, but it is not clear how the regulation would accommodate this.

In addition, it is unclear what "serialized offset credits" are. This term is used frequently in section 95990(f) but is not defined.

The verification procedures in this section would be in addition to the verification that was performed under the relevant CAR protocol when the offset was originally issued. These procedures effectively constitute re-verification of the offsets and will make early action offsets more expensive with little gain.

D. Additional sources of offsets should be considered.

The Cap and Trade Regulation restricts offsets from external programs to early-action CRTs, sector-based offsets and offsets issued under linked cap and trade programs. There is no provision to recognize offsets from other types of external offset programs such as the CDM, the Voluntary Carbon Standard, or the Gold Standard. These are well-regarded international offset programs.

The CDM constitutes the largest, best developed, most liquid, and most scrutinized offset program in the world. CDM offsets are accepted as compliance instruments in regional, national, and international emissions trading programs.[2] The CDM program is frequently examined and improved. It is subject to oversight and enforcement by an experienced international agency.

The CDM and other rigorous offset programs can be an invaluable source of offset supply, particularly in the early years of the cap and trade program when offsets from ARB protocols and from REDD are unlikely to be available in any quantity.

Linking to the CDM and other offset programs should be pursued. This will provide certainty and stimulate the development of additional offset projects. The ARB may wish to exclude certain types of CDM projects but should avoid being overly restrictive. Allowing offsets from a range of project types is important to reduce the risk that any issues with one protocol will greatly reduce the total supply of offsets.

[2] For example, the Regional Greenhouse Gas Initiative, the New Zealand emissions trading system, and the European Union trading system.

V. CONCLUSION

SCPPA urges the ARB to consider these comments in finalizing the offsets program for the California cap and trade program. SCPPA appreciates the opportunity to submit these comments to the ARB.

Respectfully submitted,

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