

COMMENTS ON ARB'S PROPOSED CAP-AND-TRADE REGULATIONS

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I. Executive Summary

The Coalition for Emission Reduction Projects (CERP or Coalition) appreciates this opportunity to provide comments on the Air Resources Board (ARB) proposed cap-and-trade regulations. CERP strongly supports the use of environmentally rigorous offsets as a critical component of achieving California’s emission reduction targets while providing cost-containment in the California cap-and-trade program. One of the key design hallmarks of a cap-and-trade program is the inclusion of large emission sources within the cap, and the use of an offsets program to integrate emission reduction project opportunities in uncapped sectors of the economy. By directly regulating only the larger emission sources, a cap-and-trade program dramatically reduces administrative costs—while using a market price signal to leverage efficient emission reductions throughout the uncapped sectors via offset projects. Because certain emission reduction opportunities in the uncapped sectors of the economy can be implemented at significantly lower costs than in the capped sector, offsets dramatically reduce the costs of a cap-and-trade program. For example, the Congressional Budget Office’s analysis of the Waxman-Markey federal climate legislation, H.R. 2454, projected annual savings from offsets to be approximately 70%.¹

Offsets also serve as a bridge to the low-carbon economy of the future. Many of the “breakthrough” technologies needed to significantly reduce GHG emissions from capped sectors have yet to be developed or deployed. A cap-and-trade program with a gradually declining cap creates an incentive to develop these technologies. While those technologies are being brought to market, offset projects can provide the verifiable and actual emission reductions needed to meet current compliance requirements. A significant component of the cost containment provided by offsets is their ability to give regulated entities flexibility in the timing of internal emission reductions.

In order to achieve the desired emission reductions at the least cost to California households and businesses, CERP urges ARB to expand the use of offsets and take the steps needed to ensure sufficient offset availability.

The Coalition thanks the ARB staff for the considerable work that went into these draft comments, and for their careful consideration of comments provided earlier. CERP is particularly appreciative of ARB’s:

- provision of flexibility in the application of protocols to specific projects through the “qualified positive” verification statement;
- utilization of a buffer reserve to ensure permanence for forestry projects;
- efforts to utilize existing offset registries;

¹ Congressional Budget Office, The Use of Offsets to Reduce Greenhouse Gases 8 (Aug. 3, 2009).

- creation of the “authorized project designee” role; and
- recognition of the contributions of early emission reduction efforts.

The comments below provide detailed suggestions on ways in which the proposed regulations could be modified to create a more effective offsets program and to ensure a reliable supply of cost-effective, high-quality offsets. Of primary importance among the proposals are these:

- The offsets usage limit should be increased in order to reduce the costs of the cap-and-trade program and ensure an efficient, manageable transition to low-carbon technologies at large emission sources.
- Offset supply, especially early offset supply, is a significant concern. ARB should expand the early action program to include additional protocols and provide full crediting periods to early action projects. ARB should streamline the re-verification of early action offset credits, and only require site visits where review of the initial verification indicates possible problems. ARB should also adopt additional protocols as soon as possible to ensure adequate supply.
- The conflict of interest regulations must be modified to take into account the small number of verifiers. Many of the requirements are unworkable in their current form. The conflict of interest requirements for the early action program should be streamlined.
- The forestry project permanence provisions should be modified to avoid “double counting” a sequestration reversal.
- Deadlines should be imposed on approved offset registries where they must act to facilitate the issuance of ARB offset credits.
- The staff report indicates that ARB intends to impose regulatory additionality across the entire Western Climate Initiative. CERP urges ARB not to take this step, as it would preclude crediting for an offset project in another state solely on the grounds that the project activity would be required by law if it were undertaken in California or another WCI jurisdiction. As a result, truly additional emission reduction opportunities will be lost, and compliance costs will be unnecessarily higher.

II. Introduction

CERP is a coalition of companies that develop and finance greenhouse gas (GHG) offset projects as well as companies that expect to be subject to GHG regulation and want the ability to use offsets to meet their compliance obligations. Some of our members operate within California as offset project developers and investors; others anticipate being subject to allowance surrender

requirements. All of our members support the goal of ensuring that California creates an environmentally rigorous and highly functional offset system as a model for other regional and federal cap-and-trade programs.

CERP's mission is to educate policy-makers and the general public about the benefits of using offset credits from GHG emission reduction projects² in uncapped sectors of the economy and in other countries as a means of meeting emission reduction goals. Utilizing offset projects expands the universe of mitigation opportunities, which can substantially lower the costs of mitigating climate change.

CERP aims to be a constructive voice in ongoing policy design efforts. Our members have diverse interests and views on climate change policy, but are united around the following principles:

- Limiting GHG emissions is best accomplished through a market-based program.
- Any GHG regulatory program should allow regulated entities to meet their reduction requirements through the use of offset credits from a range of domestic and international emission reduction activities.

CERP believes that offset credits only should be available for projects that achieve emission reductions that are additional, permanent, independently verified, enforceable, and measurable.

A list of CERP's members is provided in Appendix A to these comments.

III. Comments

A. **Offset Supply: Ensuring sufficient offset supply is of critical importance, and will require an expansion of the early action program and rapid adoption of additional offset protocols.**

CERP strongly supports ARB's efforts to incorporate offsets into the cap-and-trade program in recognition of the important cost containment role that offsets can play. By incentivizing uncapped sources to capture cost-effective emission reduction opportunities, the ARB offsets program will generate emission reductions at less cost and reduce the costs of the cap-and-trade program as a whole.

One of CERP's primary concerns with the proposed cap-and-trade regulations, however, is that the offset program will not generate sufficient offsets to meet the demand anticipated and provide the cost containment needed. The draft regulations would create an offset program with an early action component, but the program is limited to only four project types. Of the four

² Unless otherwise stated, references in these comments to "offset projects" or "emission reduction projects" describe projects involving the reduction, avoidance, sequestration, or destruction of GHG emissions.

project types, only projects to destroy ozone-depleting substances (ODS) are projected to generate significant offset volume in the near term. Because of the structure of the offsets program and the limited number of offset project types, CERP is concerned that there will not be enough offsets, and that the program will be overly dependent upon a single offset project type. There are simple but important changes that would help remedy this situation.

1. ***Early action: The early action program should be expanded to other project types and should give projects full crediting periods. Any re-verification of early action credits should be streamlined.***

Offset supply will be particularly critical during the early years of the cap-and-trade program, while offset projects are being developed under the ARB protocols and capped entities need immediately available emission reductions. CERP supports ARB's decision to bring early action credits into the program from the four specified project types and ARB's decision not to limit early action to California projects. These were important first steps to generate early supply. Yet, these steps will not generate a substantial quantity of offsets. More will be needed.

CERP encourages ARB to expand early action eligibility to other Climate Action Reserve (Reserve) protocols, including landfill methane, and to protocols from other well-respected offset registries. The Reserve was created by the state of California to encourage early actions to mitigate GHG emissions, and therefore projects developed under Reserve protocols have a special status. The Reserve protocols are high-quality, environmentally-rigorous standards, developed with input from experts, the public, and key stakeholders (including ARB). As a direct result of AB 32 and the work of the Reserve, a significant number of high quality projects have been developed in contemplation of future regulation. These projects have been generating additional, real, and verified emission reductions. The good faith emission reduction efforts governed by these protocols should be recognized and valued.

In particular, landfill methane capture projects should be included. Whatever concerns ARB has about having a chilling effect on landfill regulations in other jurisdictions are not relevant to the early action program, which recognizes projects that are already ongoing or will begin in the very near-term. Making such projects eligible for the early action program can have no negative effect on regulatory decisions in the host jurisdictions. It will, however, encourage widespread adoption of methane capture technologies at unregulated landfills, a highly efficient means of reducing GHG emissions.

In addition, CERP strongly encourages ARB to give projects registered through the early action pathway a full crediting period during which they will be eligible to earn credits that can be approved as ARB credits. Specifically, such projects should be eligible to generate offset credits for the duration of their approved crediting period and should be "shielded" against changes of

rules or methodologies during the period. As the ARB’s staff report aptly observes, this shield provides a stable regulatory environment that is critical for facilitating investment.³

Under such an approach, the regulations could provide that a qualifying early action project could have a crediting period that starts no later than January 1, 2014.

Without such crediting periods, the early action pathway will not be financially viable and projects will be forced to wait for the ARB offsets program to be fully functional or for a registry to be approved (along with verifiers) before the project can be registered and begin generating emission reductions and offset credits. Apart from the relatively small quantity of emission reductions available through already ongoing projects, the early action program will generate very few additional emission reductions if there is not a full crediting period. There will be a “gap” in offset supply, as project developers and owners wait for the ARB offset program to become operational.

Finally, CERP urges ARB to adopt a more streamlined approach to early action credit re-verification. At the outset, CERP recommends ARB re-consider whether re-verification of projects is necessary given that all CAR projects have been verified by CAR-accredited verifiers.

In the event that ARB still considers re-verification necessary, CERP urges ARB to limit the scope of verifier review to confirming that the project complies with ARB requirements and the overall reasonableness of the earlier verification results. The offset protocols eligible to generate early action credits have built in conservative assumptions and margins of error to account for any uncertainty and variation in the application of a protocol by different verifiers. *Unless there is evidence of a material error or misstatement, the regulations should provide that already verified early action credits are presumed to be valid.* If evidence of material misstatement is uncovered in the re-verification, then a more intensive review (including requantification and, where helpful, a site visit) would be warranted.

Many offset projects, particularly small projects, cannot afford to pay for a second full-scale verification of the emission reductions they generated. In order to ensure that the early action program can appropriately recognize early emission reduction efforts and generate early offset supply, it is very important that the re-verification requirements are rigorous but achievable.

Furthermore, CERP urges ARB to include regulations clarifying how any recalculation of credits resulting from a re-verification—whether an increase or decrease—will be assessed against the current holders of the credits. Providing clear rules for such recalculations is necessary to avoid having the program tied up in legal disputes. If ARB determines that a project has been issued too many offset credits (beyond the level of material misstatement), it is the Coalition’s view that the first step should be to determine what quantity of credits from the project have been voluntarily retired. If the number of voluntarily retired credits exceeds the number of “extra”

³ California Air Resources Board, Proposed Regulation to Implement the California Cap-and-Trade Program, Staff Report: Initial Statement of Reasons (“Staff Report”), Part I, Volume I at III-8 – III-9 (October 28, 2010).

credits issued, then no action need be taken. The voluntarily retired credits will “cancel out” the excess issuance, and ensure that the AB 32 offset program is whole.

If the number of “extra” offset credits exceeds the number of credits voluntarily retired from a project, CERP believes the most equitable and efficient means of addressing the “balance” of extra credits is to apply a recalculation *pro rata*. For example, if re-verification of a CAR-approved project resulted in a 10% decrease in vintage year 2009 CRTs for that project, and zero credits had been voluntarily retired from that project, ARB would allow all holders of vintage year 2009 CRTs from that project to exchange their credits for compliance credits at no greater than a 100:90 ratio. (If, however, 10% or more of the credits from the project had been voluntarily retired, no recalculation would be needed.)

2. *New protocols: ARB should quickly adopt additional protocols.*

In order to ensure sufficient offset supply, it will be critically important for ARB to adopt additional protocols. CERP urges ARB to adopt additional protocols in early 2011. In addition, because it takes some time to finance and develop offset projects, CERP also encourages ARB to publicly identify, as soon as possible, the protocols being considered for adoption.

CERP urges ARB to focus first on project types for which there are well-established methodologies or that have the potential to generate large quantities of emission reductions. Project types with established methodologies include methane collection at landfills, coal mines, and natural gas systems and non-landfill projects that involve collection, combustion, or avoidance of emissions from organic waste streams. Project types that have the potential to generate large quantities of emission reductions include agricultural projects involving nutrient and rangeland management.

Finally, CERP asks that ARB establish a transparent process for protocol consideration, so that stakeholders can provide input. Offset project developers and investors have useful and important real-world experience to offer, and can help ensure that the offset protocols adopted by ARB will be effective, usable, and environmentally rigorous. CERP asks that ARB make publicly known which protocols are under consideration and the mechanics of the protocol consideration process. This transparency will help provide predictability for the marketplace and ensure a stable offset supply.

In addition, CERP urges ARB to allow covered entities to carry over any portion of their offsets usage quota that is unused during a compliance period. Because there may not be sufficient offset supply available in some compliance periods to meet demand, some covered entities may not be able to obtain the quantity of offsets they are allowed to use, and therefore will lose the cost containment that the offsets could have supplied. To protect the ability of offsets to provide cost containment, covered entities should be able to use additional offsets in subsequent compliance periods, up to the quantity of “unused” offsets.

B. Offsets usage limit: The offsets usage limit severely and unnecessarily constrains the ability of offsets to generate cost-effective emission reductions.

CERP strongly supports the increase in the offsets usage limit to 8% of an entity's compliance obligation. The offsets usage limit remains, however, a severe and unnecessary limit on the ability of offsets to provide cost containment to the California program while delivering environmentally rigorous emission reductions.

At the very least, the proposed regulations should provide for the offsets usage limit to be modified in the future should allowance prices become too high. Specifically, CERP recommends that in the event that half of the allowances from the Allowance Price Containment Reserve have been purchased, the offset usage limit should increase to provide additional cost containment. At that point, ARB should also use revenue from the sale of allowances from the Reserve to purchase offsets to “refill” the Reserve. Such safeguards are not only reasonable, but essential to ensure that cost containment will be available when it is needed.

The atmosphere is indifferent to where greenhouse gases are emitted. It is equally indifferent to where emission reductions originate. An efficient climate mitigation program would observe similar neutrality. The emission sources that are chosen to be included under the “cap” in a cap-and-trade program tend to be the larger sources of GHGs, because they can be efficient participants in a trading program. They do not otherwise differ from the many smaller sources of GHGs. An emission reduction made by a small source has the same impact on overall emission levels as an emission reduction made by a large source. To be sure, the large, capped emission sources will be required to make large contributions to emission reductions so that California's emission reduction goals can be achieved. But there is no sound policy rationale for the current approach of unduly restricting emission reduction opportunities from offsets as a mechanism for forcing large sources to make inefficient emission reductions in the near-term, when many of the technologies needed for low-carbon energy generation and industrial production have yet to be developed and deployed.

Offsets can serve as a bridge to the low-carbon economy of the future. Because certain emission reduction opportunities in the uncapped sectors of the economy can be implemented at significantly lower costs than in the capped sector, offsets dramatically reduce the costs of a cap-and-trade program.

A cap-and-trade program with a gradually declining cap creates an incentive to develop the low-carbon breakthrough technologies needed to dramatically reduce emissions from large GHG sources. While those technologies are being brought to market, offset projects can provide the verifiable emission reductions needed to meet current compliance requirements. A significant component of the cost containment provided by offsets is their ability to give regulated entities flexibility in the timing of internal emission reductions.

By limiting offsets usage to approximately 8% of entities' compliance obligations—as ARB has proposed in the draft regulations—ARB is unduly limiting the emissions reduction potential and

cost containment that offsets can provide, and increasing the costs of the cap-and-trade program for California households and businesses.

CERP urges ARB to increase the offsets usage limit. At the very least, the proposed regulations should provide for the reevaluation of the offsets usage limit in the future if allowance costs become high, and provide an automatic recalibration of the limit in the event that half the allowance reserve is depleted.

C. **Conflict of interest requirements: The verifier conflict of interest requirements in the draft regulations are prohibitively cumbersome.**

CERP respectfully urges ARB to revisit the conflict of interest requirements in the offset provisions. To be clear, the Coalition strongly believes that the offset program needs to be free of the contamination of conflicts of interest and supports the establishment of rigorous rules to provide such assurances. However, it is important to find a means to avoid conflicts of interest that still allows the offsets program to operate effectively.

In particular, the regulations need to take into account the fact that the AB 32 program likely will have a relatively small universe of verifiers. There are not many companies with experience in offset verification, and many of these companies perform other, non-verification services for offset developers and other customers as a core part of their business model. The number of verifiers with the required special certification in a specific offset project type will be even smaller. Offset project developers similarly tend to specialize in a small number of offset project types. Therefore the number of verifiers eligible to verify a specific project type who are not currently working for an offset project operator on another project or in some other capacity may be zero. The limited pool of available verifiers already is, and will continue to be, particularly challenging in the near-term for projects seeking early action crediting.

It is also important to acknowledge that a business relationship does not necessarily create a conflict of interest or prevent a verifier from performing effectively. A verifier's financial success ultimately depends upon its ARB accreditation. Under the proposed regulations, verifiers will be audited frequently and must provide a transparent record of the verification process. ARB should be prepared to rely upon other mechanisms, such as the audit process, rather than impose an impractically broad definition of conflict of interest.

For these reasons, oversight of conflicts of interest is very important, but also must be constructed in such a way to allow projects to go forward.

The conflicts-of-interest regime reflected in the current draft—which appears to limit verifiers and project operators to one-off interactions once every three years—is impracticable. Were the regulations finalized in their current form, the avoidance of conflicts of interest would come at the cost of a substantial backlog of projects awaiting verification, potential increases in verification costs, and a reduction in offset supply. For these reasons, CERP urges ARB to consider revisions as explained below.

1. ***Verifier replacement: The verifier replacement requirements must be adjusted because there will not be enough verifiers to allow offset project operators and authorized project designees to meet the requirements.***

The proposed conflict of interest regulations would require an offset project operator or authorized project designee⁴ to change verifiers every six years to a verifier that had not been used by the offset project operator during the previous three years.⁵ If these verifier-replacement requirements applied only to a specific project—i.e., if each offset project had to change verifiers every six years—that might be feasible (although at the cost of considerable efficiency, as it takes a substantial amount of time for verifiers to understand a project.) However, as the regulations are currently drafted, they appear to impose a second limitation: the project operator may not utilize as a replacement verifier any verifiers the operator has employed on other projects at any time in the last three years.

If an offset project operator has multiple projects of a specific type, and after six years has to find a replacement verifier for each of those projects that has not worked for that operator for at least three years—there simply will not be enough verifiers with the requisite project type expertise to perform the verification. In addition, this approach creates a risk of encouraging the proliferation of small, inexperienced, and possibly short-lived verifier companies to fill the gap.

CERP respectfully urges ARB to modify this requirement. One approach would be only to require the periodic change of verifier for a particular project, but without regard to whether the replacement verifier also has worked for the project operator on other projects.

In addition, it will be important for ARB to move swiftly to accredit verifiers for the different project types.

2. ***Early action conflict of interest requirements: The verifier conflict of interest requirements for early action credits are excessively burdensome, and should be streamlined.***

The draft regulations contemplate that owners of Climate Reserve Tonnes (CRTs) of specific vintages from qualifying projects will be able to exchange those CRTs for offset credits that may be used for compliance in the AB 32 program—subject to re-verification of the project by an ARB-accredited verifier.⁶ In many cases, the CRTs from an individual project now are owned by a multitude of buyers. Yet, under the proposed regulations, ARB’s verifier conflict-of-interest standards would be assessed against *every owner* of a credit that could qualify as an early

⁴ Hereinafter the term “offset project operator” or “project operator” will be used to refer to both offset project operators and authorized project designees.

⁵ California Air Resources Board, Proposed Regulation to Implement the California Cap-and-Trade Program, Appendix A: Proposed Regulation Order (“Proposed Order”) § 95979 at A-145 - A-148 (October 28, 2010).

⁶ § 95990, Proposed Order at A-171 – A-175.

action offset credit under the ARB program.⁷ This approach would result in a massively complex and time-consuming conflict of interest assessment process. In addition, it would likely result in the same project being re-verified by multiple verifiers. Not only would this be costly and inefficient, but the verifiers could reach different conclusions about the quantity of offsets earned, which would be difficult to reconcile. These results would defeat the aim of making early offset credits a source of readily available cost containment.

CERP urges ARB to reconsider its approach to verifiers and conflicts of interest in the early action context. One approach would be for ARB itself to appoint a verifier for each early project, which could be supported by charging a small fee for every early action offset credit submitted from that project.

Alternately, ARB could apply the conflict-of-interest requirements only against entities that own a substantial portion of credits from an offset project (*e.g.*, 40%).

An option that would work well for ongoing projects would be for ARB to allow existing, early action-eligible credits to be re-verified during the initial verification process for a project that registers under the ARB protocol, with the conflict-of-interest assessment performed only against the current offset project operator.

In any event, it is important to ensure that an early project need only have at most a single re-verification.

Finally, it would be helpful if the regulations could make clear that a project's qualification for early action credits does not bar the same project from being approved under an ARB protocol, provided that it may not earn two credits for the same ton of emission reductions.

D. Forestry permanence: The forestry sequestration reversal provisions should not require double compensation for a reversal.

CERP strongly supports ARB's establishment of a "buffer reserve" to compensate the offset program in the event that a forest sequestration project experiences an unintentional reversal.⁸ The reserve, which will be filled with credits withheld from forestry projects, will ensure that the offset program will be made whole in the event that an unintentional occurs. If an intentional reversal occurs, the proposed regulations also require the offset project operator to submit to ARB an amount of credits equivalent to the reversal,⁹ which appropriately puts the replacement obligation on the entity with the greatest control over the project's success.

⁷ § 95990, Proposed Order at A-174.

⁸ § 95983, Proposed Order at A-157 – A-159. CERP also recommends, however, that ARB remain open to the adoption of new, innovative ways of ensuring the permanence of sequestration projects.

⁹ § 95985, Proposed Order at A-160 – A-161.

However, the proposed regulations—in addition to providing these replacement provisions—appear to require that the offset credits issued for emission sequestrations that subsequently undergo a reversal be canceled.¹⁰ This is effectively double-counting the reversal:

Step 1: The reversal occurs.

Step 2: If the reversal is unintentional, an equivalent quantity of credits from the buffer reserve is cancelled. This makes the offset program whole. (Note: any credits in the reserve that represent a reversed sequestration must also be canceled.) If the reversal is intentional, an equivalent quantity of credits must be submitted to ARB by the offset project operator, and will be cancelled. This makes the offset program whole.

Step 3: The credits representing the reversed sequestration are cancelled under Section 95985. At this point, the offsets program has been compensated for the reversal twice.

If the already-issued credits are canceled, then the buffer reserve and the replacement obligation serve no purpose, and forestry offset credits will be non-homogenous and illiquid. Compliance buyers would inefficiently discount these offsets in the market (because they will not have the information and expertise needed to accurately assess the risk of reversal) and/or will include a replacement obligation in the offset purchase contract. These are precisely the problems that the buffer reserve and the offset project operator replacement liability are supposed to prevent. Note also that in the event of a partial reversal, it will be extremely difficult to determine which already-issued offset credits should be cancelled.

CERP strongly recommends that ARB remove the § 95985 requirement for cancellation in the event of a forest sequestration reversal, and rely instead on the buffer reserve and project operator liability mechanisms to address reversals.

In addition, CERP urges ARB to harmonize the requirements applying to forestry projects that undergo an intentional reversal. In the Proposed Regulation Order, it provides that a project that undergoes an intentional reversal is automatically terminated.¹¹ The ARB U.S. Forest Project Protocol, however, sensibly provides that if a forestry project experiences a reversal but its actual live standing carbon stocks are still above approved baseline levels, it may continue without termination provided the reversal has been compensated.¹² The approach taken by the protocol is both reasonable and appropriate. So long as live standing carbon stocks remain above baseline levels, the project has generated real, additional, verifiable carbon sequestration and should continue. Minor “reversals” are also a fact of life. In the course of a 100 year forestry management project, typical silvicultural practices may require harvesting beyond the levels envisioned by a protocol in order to balance tree age classes and sustainable forest growth.

¹⁰ *Id.*

¹¹ § 95983, Proposed Order at A-159.

¹² California Air Resources Board, Staff Report and Compliance Offset Protocol for U.S. Forest Projects, Section 7.4 at 60 (October 28, 2010).

These minor reversals, if compensated for through the submission of an equivalent quantity of compliance instruments, should not result in the termination of a forest project.

- E. **Regulatory deadlines: The proposed regulatory deadlines are potentially very helpful in ensuring an efficient offsets program and predictable offset credit supply. Certain critical deadlines, however, are missing and others are unreasonably severe.**

The proposed regulations helpfully lay out a series of deadlines for ARB and approved offset project registries to act during the offset project listing and verification processes. Such deadlines will provide critical information to the market and capped entities about the future supply of offset credits and ensure that the offsets program runs efficiently. However, the proposed regulations fail to impose deadlines at certain key junctures. In addition, the penalty for an offset project operator or a verifier missing a deadline is unreasonably severe.

1. ***Approved registry deadlines: The regulations should impose deadlines on approved offset project registries where ARB credit issuance requires the registries to fulfill certain responsibilities.***

There are key points in the offset credit generation process where an offset project registry must act in order to facilitate the issuance of ARB offsets in exchange for approved registry offsets. At two critical points requiring registry action, no deadline is imposed upon registries:

- Credit transfer: In order for a project registered with an approved offset registry to obtain ARB credits, the offset registry must submit the relevant paperwork to ARB.¹³ The proposed regulations do not require the offset registry to complete this action within any specified period of time, giving ARB and the offset project operator no guarantee of timely credit issuance—even if the operator fulfills all of its responsibilities in a timely manner. The proposed regulations should be modified to require an offset registry to submit the required paperwork within five working days of receiving a transfer request from the offset project operator. If a transfer request is submitted before offset registry credit issuance, the proposed regulations should require the relevant paperwork to be submitted within five working days of credit issuance.
- Credit cancellation: In order for ARB to issue offset credits to a project registered through an approved offset project registry, the registry must first cancel the original credits.¹⁴ There is no deadline on this action, which creates excessive uncertainty for the credit owners. CERP urges ARB to require approved registries to cancel the relevant credits within one working day of receipt of a request from ARB.

¹³ § 95981(d), Proposed Order at A-154 - A-155.

¹⁴ § 95981(d), Proposed Order at A-156.

2. ***Deadline penalty: The regulations disqualify emission reductions quantified in an offset project data report or a verification statement that is submitted after the relevant deadline. This penalty is excessively harsh and should be modified.***

The regulations require that an Offset Project Data Report be submitted within three months of the end of the calendar year, which is also the emission data collection period.¹⁵ The Verification Statement for those emission reductions must be submitted within nine months of the end of the calendar year data collection period.¹⁶ The regulations also appear to provide that if one of these deadlines is missed, the emission reductions in the report or statement become permanently ineligible for crediting.¹⁷ Both the deadlines and the consequence for missing them are unreasonable.

When emission reduction quantification and verification are going smoothly, a project will likely be able to meet these deadlines. When problems arise, however, it may take time to resolve them. If there is a question of protocol interpretation, or the need for a non-material deviation from the protocol's requirements, ARB or the approved offset project registry (or both) may need to be consulted—and may not be able to resolve the issue and give clear guidance immediately. An offset project may need to change verifiers. A vital individual on a verification team could fall ill at a critical point. A verifier could be late with a verification statement through no fault of the offset project operator. It may be difficult to find a verifier that is qualified and not excluded due to the conflict of interest requirements. When such circumstances arise, the goal should be to resolve the problem and ensure a thorough quantification and verification process—not to rush to meet an arbitrary deadline. Given the many and varied reasons that quantification and verification could be delayed, the disqualification of emission reductions after a missed deadline is unwarranted.

CERP recognizes the need for ARB to ensure that projects are verified in a timely manner. However, CERP urges ARB to modify the proposed regulations to allow offset project operators and verifiers to apply for a deadline extension should such extenuating circumstances arise, with no penalty.

3. ***Verification schedule: The standardized verification schedule is likely to create a verification and issuance traffic jam, and should be revised.***

Under the proposed regulations, all ARB-eligible offset projects will be undergoing verification between April and September.¹⁸ We are unclear about the expected benefit of this requirement. Given the limited number of verifiers, the standardized schedule is likely to create problems for

¹⁵ § 95976(d), Proposed Order at A-119.

¹⁶ § 95977(d), Proposed Order at A-125.

¹⁷ § 95976(d), Proposed Order at A-119; § 95977(d), Order at A-125.

¹⁸ *Id.*

project operators, verifiers, ARB, and approved offset registries. The result could be increased verification costs to project owners who must now contract with a limited pool of verifiers who will be in artificially high demand during this time period. The cost impacts imposed on small projects by this market restriction would be especially pronounced, assuming they can even find a qualified verifier willing to undertake a small project. A more flexible verification schedule would help avoid this problem as well as the deadline issues discussed above.

CERP urges ARB to provide more flexibility in the timing of verification. One option would be for ARB to require offset project operators to submit evidence that verification has been initiated (e.g. a signed verification contract) within 3 months of the end of the prior data collection period. This would help to ensure that projects undergo verification promptly, while allowing offset project operators and verifiers to responsibly manage the verification process.

4. *Credit issuance: The credit issuance timeline involves seemingly unnecessary delays, and should be shortened.*

Under the proposed regulations, ARB will have 15 calendar days after issuing credits to a project to notify the recipient(s).¹⁹ ARB will then have an additional 15 working days to transfer the credits to the recipients' accounts.²⁰ It is difficult to understand why these two simple, mechanical actions would take so much time after ARB has already reviewed the project and determined how many credits to issue. CERP urges ARB to have notification and credit transfer follow more rapidly upon ARB's determination of the quantity of credits to be issued.

5. *Appeal timing: The timing of the appeal process should be modified as it may not be workable.*

If an offset project data report is found to be ineligible, the proposed regulations would give the offset project operator 30 calendar days to submit a revised version.²¹ (Note that it is problematic that there is no deadline for when ARB or the approved offset project registry must inform the offset project operator that the report has been found to be ineligible, especially as the 30 days begins from the date of the determination of ineligibility.) A revised verification statement must be submitted within 15 calendar days.²² (It is unclear when this 15 day period begins.)

The proposed regulations further provide that if an offset project operator disagrees with a determination made by an approved registry, they can petition ARB, provided the process is reinitiated within 60 calendar days of the applicable verification deadline.²³ However, given that there is no deadline for when ARB or an approved offset registry must determine whether an offset project data report meets the specified requirements, or for when an approved offset

¹⁹ § 95981, Proposed Order at A-154.

²⁰ § 95981, Proposed Order at A-156.

²¹ § 95977, Proposed Order at A-141-142.

²² *Id.*

²³ § 95977, Proposed Order at A-142-143.

project registry must determine whether a revised offset project data report and verification statement are acceptable, it may not be possible to meet the 60 day deadline. CERP urges ARB to eliminate the 60 day deadline, and instead require appeal to ARB within 30 calendar days of the final contested decision by the approved offset project registry.

F. **Regulatory additionality: Imposing the most stringent regulatory additionality requirement across multiple legal jurisdictions needlessly wastes low-cost emission reduction opportunities.**

The Staff Report suggests that ARB’s intent is to define additionality such that the most stringent regulatory requirement in any jurisdiction will be assumed to be in effect in all of the other jurisdictions throughout the Western Climate Initiative (WCI).²⁴ Under this approach, even if an emission reduction project activity undertaken in a particular WCI jurisdiction were beyond business-as-usual and not required by law in that jurisdiction it nevertheless would be ineligible for crediting if it were an activity required by law in *another* WCI jurisdiction. CERP strongly urges ARB to revisit this approach because it will deny California and the WCI system the benefit of any number of emission reduction projects that are truly additional, thereby constricting offset supply and increasing compliance costs. Disqualifying these truly additional emission reductions would also render ineligible offset projects types that would otherwise be a significant source of high quality emission reductions in the early years of the California program, such as methane capture projects at landfills.

According to ARB’s analysis of offset supply for the California program, projects involving destruction of ozone depleting substances (ODS) are projected to supply 91% of the available offsets between 2012 and 2020. To be sure, ODS destruction projects can provide high quality, cost-effective offset credits and are therefore an important source of cost containment. However, in our view, it is risky to place such a heavy reliance on one offset project type to generate essentially all of the cost containment for the cap-and-trade program. CERP urges ARB to facilitate the generation of emission reductions by authorizing a diverse portfolio of offset project types, and to focus initially on offset project types that can generate cost-effective offsets in the near term.

Our understanding is that this “regulatory additionality” proposal is based on an assumption that the availability of income from offsets would discourage other jurisdictions from adopting regulations such as those in California—and, conversely, that denying such income would encourage promulgation of such regulations. In our view, this assumption is highly speculative, and rather reductionist. States adopt rules, or do not adopt them, for any number of reasons. The ARB’s proposal seems to overstate the influence of the California offsets program on policies in other states.

Yet, this account also *understates* the possibility that California’s offsets program could *promote* promulgation of new regulations, *e.g.*, by providing financial incentives for the installation of

²⁴ Staff Report at III-11.

emission capture technologies, thereby making it easier for other jurisdictions to later require their use. If California’s offsets program were to help make certain abatement activities in other states effectively “business-as-usual,” such activities would no longer qualify for offset credits and there would be little resistance to a regulatory requirement that they be maintained.

In any event, there is no reason to make an *a priori* assumption about the influence of the California offsets program on other jurisdictions. A better approach would be to launch the program without this “regulatory additionality” proposal. If, after some initial period of time, there is evidence that the California offset rules are discouraging other jurisdictions from adopting regulations similar to those in the California system, the relevant offset project type(s) could be made ineligible.

G. Trade information: ARB should clarify what constitutes a “trade” in compliance instruments, and what it intends to do with the trade information it collects.

Under the proposed regulations, ARB will collect detailed information about all “trades” involving compliance instruments.²⁵ It is not clear, however, what constitutes a “trade.” A carbon market encompasses all manner of transactions, including transactions that close on a particular day but contemplate actual physical delivery on a future date. A straightforward approach would be for ARB to collect information on transactions in which compliance instruments are actually transferred from the account of one registered entity to the account of another.

In addition, ARB should clarify whether it intends to make this information public—and, if so, whether it will be disclosed in an aggregated form or in a form that provides information about specific transactions. Market participants generally see certain transactional information, such as price terms, as highly sensitive. Keeping such information confidential can be important for ensuring an efficient and competitive marketplace.

H. Record retention: The proposed record retention requirements are unnecessary and excessively burdensome.

Under the proposed regulations, the offset project representative is required to maintain all of the information relevant to measuring and verifying emission reductions or sequestration for five years after the end of a crediting period for a non-sequestration project, and for 100 years beyond the end of crediting for a sequestration project.²⁶ The duration of these retention requirements is, to say the least, commercially unrealistic—many corporations do not exist for 100 years.

It is our understanding that the 100-year requirement may be based on a similar requirement imposed by the Climate Action Reserve. In the context of the Reserve, some kind of record

²⁵ § 95921, Proposed Order at A-107 – A-108.

²⁶ § 95976, Proposed Order at A-118 – A-122.

retention requirement might make sense because the Reserve is not a governmental entity, but rather a nonprofit public benefit corporation. It is quite possible that the Reserve could cease to exist well before the crediting period ends for many of its listed projects. By contrast, ARB is an agency of the state government, and is tasked with regulatory oversight. It is reasonable to expect ARB to bear the burden of long-term record retention for the offset projects it oversees. CERP suggests that ARB require any information it may need in the future to be submitted to ARB at the time of verification.

- I. **Offsets program details: Further definition of some aspects of the ARB offsets program would be helpful.**
 1. ***Offsets program timing: ARB should clarify when the ARB offsets program will be operational.***

Many offset project developers will want to know when the ARB offsets registry will be operational, which will affect their decision of whether to register a project with ARB versus other registries. Any information you can provide on when ARB will be ready to make decisions on early action credits and to register offsets under the ARB protocols would be very helpful.

2. ***Appeals: The process of appealing from ARB decisions on projects should be more clearly defined.***

CERP urges ARB to provide more clarity on the process by which an offset project operator can appeal a decision of ARB regarding a project listing or verification.

- J. **Sectoral crediting: CERP supports ARB's creation of a sectoral crediting program, including a sectoral REDD program, which will be an important component of offset supply.**

CERP supports ARB's intention, as reflected in the proposed regulations, to create a sectoral crediting program for international emission reduction activities, including projects to reduce emissions from deforestation and forest degradation (REDD).²⁷ CERP welcomes the agreements forged with Acre and Chiapas, and encourages ARB to swiftly implement these agreements by creating a sectoral crediting framework for these states.

CERP is concerned, however, with the phased-in sectoral credit use limit within the offsets usage limit. Under the proposed regulations, regulated entities could only use sectoral offsets for 25% of their compliance obligation during the first two compliance periods, and for 50% during the third compliance period.²⁸ If there is a shortage of non-sectoral offsets, and a steady supply of sectoral offsets, this usage constraint will severely and unnecessarily hamper the cost containment value of offsets. CERP urges ARB to modify the regulations to empower the

²⁷ §§ 95991 - 95994, Proposed Order at A-176 – A-178.

²⁸ § 95854, Proposed Order at A-68 – A-69.

Executive Officer to increase the sectoral offsets usage quota if insufficient quantities of non-sectoral credits are available at reasonable prices.

In addition, the calculation of the sectoral offsets limit as described in the proposed regulations enhances the program's vulnerability to non-sectoral offsets shortages. The sectoral offsets usage limit is calculated as a percentage of the offsets an entity turns in for compliance, rather than as a percentage of the offsets usage limit.²⁹ This means that a shortage in non-sectoral offsets will also constrain the quantity of sectoral offsets that can be used, precisely when they will be most needed for cost containment. It is our understanding that ARB staff members are aware of this problem, which should be rectified.

K. *Variations: CERP supports the potential use of qualified positive verification statements, and urges ARB to create a public database of approved variations.*

CERP strongly supports the use of qualified positive verification statements where nonconformance with a protocol does not result in an offset material misstatement.³⁰ This approach will make it easier for projects to obtain reasonable variations from a protocol's requirements.

To be sure, CERP prefers a standardized approach to offset protocols instead of a less efficient, more cumbersome project-by-project approach. However, a standardized approach needs to make some room for reasonable variations because "real world" projects can encounter issues not anticipated by a protocol's designers. The qualified positive verification pathway will allow offset project operators and verifiers to adjust to real-world circumstances while ensuring the high environmental integrity of emission reductions.

CERP urges ARB to collect and make public a list of "nonconformances" (or "variations") found to be valid by a verifier. Often different offset projects will encounter the same problem, and it will be more efficient if the operators and verifiers are not forced to reinvent the wheel each time. To be clear, these variations need not be "precedents;" the burden could remain on an offset project operator to make the case for a variance. Nevertheless, a public list of previously-approved variations will bring some order, consistency, and efficiency to the process.

In addition, a public list of variations can identify the kind of recurring issues that should be considered in the process of developing a new or revised methodology.

L. *Approved registries: CERP supports the use of approved offset project registries to list projects and oversee verification, but some modifications will be required to make this process workable.*

²⁹ *Id.*

³⁰ § 95802, Proposed Order at A-32; § 95980, Order at A-153.

CERP supports the use of approved offset project registries for project listing, verification oversight, and credit issuance—in combination with an expedited, transparent process for exchanging registry-issued credits for ARB-issued credits. CERP also supports the use of ARB-approved verifiers to meet AB 32’s requirement for ARB oversight of verification. There are, however, certain aspects of the offset project registry mechanism that might prove problematic.

1. ***Approval period: The five year approval period for offset project registries creates too much insecurity for projects registered at approved registries. ARB should provide greater certainty for registered projects.***

The proposed regulations provide that an offset project registry could be approved to participate in the ARB program for five years, subject to renewal.³¹ This five year approval period—which is shorter than any project’s crediting period—will create considerable uncertainty for offset projects registered with those registries, and therefore limit the registries’ appeal and utility. CERP recommends that ARB provide an accelerated process by which projects registered with a registry that becomes “un-approved” can re-register with ARB, and continue any on-going crediting period. CERP also recommends that ARB clarify that the validity of already-issued credits will not be compromised if the issuer-registry does not secure a subsequent approval from ARB.

2. ***Protocol guidance: The proposed regulations should specify what will happen if ARB disagrees with protocol guidance or interpretation supplied by an approved registry.***

Under the proposed regulations, ARB will be notified of all protocol guidance and interpretations provided to verifiers and offset project operators by approved registries.³² However, the proposed regulations do not clarify what will happen if ARB disagrees with that guidance. Offset project operators and verifiers need to know that they can rely on guidance issued by an approved registry, and/or that in the event that ARB disagrees with such guidance, the offset project operator and verifier will be notified and given sufficient time to adjust to the revised guidance.

- M. ***Buyer liability: Buyer liability in the event of fraud or mistake will needlessly make the offsets market less liquid, and creates inefficient incentives.***

CERP strongly opposes the buyer liability framework in the proposed regulations. Under the proposed regulations, if already-issued offset credits are found to be ineligible due to mistake or fraud, the credits will be canceled from any holding account.³³ Any credits that have already been submitted for compliance will also be canceled, and the entity that submitted the credit will

³¹ § 95986, Proposed Order at A-165.

³² § 95987, Proposed Order at A-168.

³³ § 95985, Proposed Order at A-160-161.

be responsible for replacing the credit.³⁴ This cancellation and replacement requirement will make offsets non-homogenous (because many offset sale contracts will incorporate a tailored credit-replacement clause) and reduce the liquidity of the offsets market.

CERP urges ARB to instead allow already-issued credits to remain valid, and require the relevant offset project *operators or verifiers* to submit an equivalent quantity of replacement credits to be retired. This system would place the replacement liability with one of the parties that have the greatest control over the quality of emission-relevant data and reporting. It will also help ensure that offsets will be a homogenous, liquid commodity.

In addition, such an approach will be easier to administer because ARB will only be required to impose the replacement obligation on a single entity, rather than on every entity that has submitted a credit retroactively found to be ineligible.

Failing to place the liability on the party with control over the risk unfairly penalizes innocent parties, and generates considerable inefficiency in the market. Although parties can contractually reallocate the liability, this greatly complicates offset transactions. In addition, the replacement liability is imposed on a party without good information about the actual risk of ineligibility, which will lead to the risk being inefficiently overvalued. As a result, the offsets market will not function efficiently and the costs of obtaining offsets will rise. ARB can avoid all of these deleterious outcomes by imposing the replacement liability where it belongs—with the party that is responsible for the mistake or fraud.

Regardless of where ARB assigns replacement liability, CERP also strongly urges ARB to put a statute of limitations on the “mistake” liability of one verification cycle, in order to make it commercially manageable. In addition, CERP asks that ARB provide greater specificity regarding what circumstances would justify a finding of ineligibility due to mistake.

N. Linkage: CERP supports linkage with other programs.

CERP supports ARB’s inclusion of linkage language in the proposed regulations,³⁵ and urges ARB to move forward with linkage with qualified programs as soon as possible in 2011.

O. Crediting period renewals: Crediting periods renewals should not be limited where projects remain additional.

CERP supports ARB’s determination to assign non-sequestration projects a crediting period of seven to ten years,³⁶ although CERP believes that many project types will need a 10-year crediting period to ensure financial viability. In addition, CERP strongly supports ARB’s decision to allow non-sequestration projects to apply for two crediting period renewals rather

³⁴ *Id.*

³⁵ § 95941, Proposed Order at A-109.

³⁶ § 95972, Proposed Order at A-112.

than one, as was proposed earlier. Nevertheless, it is our view *any* arbitrary limit on crediting period renewals is unnecessary and inefficient. When applying for a renewed crediting period, an offset project is assessed against an up-to-date additionality standard. If a project is still generating additional emission reductions at the end of a third crediting period, there is no justification for shutting the project down and wasting cost-effective emission reductions.

In addition, CERP urges ARB to make a clear statement in the proposed regulations that an offset project will be always be assessed against the compliance protocol in effect at the time the project is initially listed or, during subsequent crediting periods, against the protocol in effect at the time the project applies for a renewed crediting period. Project developers and investors need certainty that the rules that govern the project will remain constant throughout a crediting period to know that they can re-coop their initial investment.

P. Authorized project designees: CERP supports ARB’s adoption of the authorized project designee concept.

CERP strongly supports ARB’s use of the “authorized project designee”³⁷ role to enable a third party to be responsible for project registration and other tasks. This will significantly improve the efficiency of the offsets program.

Q. Forest project verification: Forest project verification requirements should allow for annual remote verification of offset credits.

Forest sequestration projects are unique in many ways, most particularly their longevity. CERP supports ARB’s proposal to allow a forestry project to choose to verify its emission reductions at six year intervals.³⁸ However, such episodic verification will produce a lumpy stream of offset credits, which will generally be disfavored by investors and customers. CERP requests that ARB modify the proposed regulations so that a forestry offset project may earn offset credits annually based on a remote data review by the verifier, provided that the verifier also undertakes a site visit at least once every six years or more frequently as the verifier deems advisable.

R. Compliance penalty: Offsets should be eligible for use in paying a penalty.

Under the proposed regulations, offsets cannot be turned in as part of the compliance instrument penalty paid by a covered entity that misses a compliance deadline. The entity must turn in four allowances for each compliance instrument outstanding.³⁹ The ineligibility of offsets in this context will further devalue offsets relative to allowances. CERP asks ARB to consider allowing covered entities to turn in offsets for at least some portion of a penalty obligation.

³⁷ § 95802, Proposed Order at A-8 et seq.

³⁸ § 95977, Proposed Order at A-125.

³⁹ § 95857, Proposed Order at A-71 – A-74

S. *Definition correction: The definition of voluntarily associated entity needs to be corrected.*

CERP strongly supports ARB's creation of an open market for trading in compliance instruments. CERP believes that allowing a wide variety of entities to participate in the market will ensure a liquid market and reduce the potential for any one entity to exercise market power. However, the definition of "voluntarily associated entity" in the proposed regulations provides that such an entity must have an intent to voluntarily retire compliance instruments.⁴⁰ This appears to be an error because other provisions make clear that a "voluntarily associated entity" can be a broker or other liquidity provider.

IV. Conclusion

We appreciate your consideration of our comments. Please let us know if you would like to discuss these concepts, or would like further elucidation of any of these points. We look forward to continued work with you to ensure that the California offsets program is effective, efficient, and environmentally rigorous.

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⁴⁰ § 95802, Proposed Order at A-37.

Appendix A: Members of the Coalition for Emission Reduction Projects (CERP)

American Electric Power

Environmental Credit Corp.

Camco

Equator, LLC

C-Trade

Leaf Clean Energy Company

Deutsche Bank

Dominion

Duke Energy

PG&E Corporation

Element Markets

Verdeo Group

El Paso Corporation