COMMENTS ON ARB'S PRESENTATION ON OFFSETS AND LINKAGE IN A CALIFORNIA CAP-AND-TRADE PROGRAM ON JUNE 22, 2010

Submitted by:

Coalition for Emission Reduction Projects (CERP)

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Cap-and-Trade Program

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I. Executive Summary

The Coalition for Emission Reduction Projects (CERP) appreciates this opportunity to provide comments on the Air Resources Board (ARB) June 22nd staff presentations on Offsets and Linkage in a California Cap-and-Trade Program. CERP supports reliance on environmentally rigorous offsets to provide cost-containment in the California cap-and-trade program, and offers the below comments with the goal of maximizing the cost effectiveness of California's efforts to abate greenhouse gas emissions.

II. Introduction

CERP is a coalition of companies that develop and finance 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 projects[1] 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 the risk of 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.

[1] 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.

A list of CERP's members is provided in Appendix A to these comments. CERP's recommended policy principles on offsets are provided in Appendix B to these comments.

III. Comments

A. Linkage with Other Offset Programs

CERP strongly supports ARB's intention to link with other regulatory cap-and-trade systems and nongovernmental offset programs. The ARB's proposed offset program would begin with a limited set of protocols, which would generate offsets from a narrow set of sectors in the United States. Generating sufficient offset supply to provide cost containment during the early years of the cap-and-trade program is a concern. Linking with other programs that generate offsets of high environmental integrity will expand the universe of emission reduction opportunities and lower the costs of meeting California's emission reduction targets. In order to generate additional offset supply as quickly as possible, CERP urges ARB staff to include linkage language in the cap-and-trade regulations in 2010 and begin to link to other programs in early 2011.

1. Nongovernmental Offset Programs

Specifically, CERP urges ARB to link with the Climate Action Reserve (Reserve) as soon as possible, and to link to the full suite of Reserve protocols that have been approved and adopted to date. This includes not just the three protocols that ARB plans to link with for early action—Forestry 2.1 and 3.0, Livestock 2.0, and Urban Forestry 1.0—but also protocols for emission reduction projects involving nitric acid production, organic waste composting, organic waste digestion, and methane capture at landfills and coal mines. The Reserve has developed environmentally rigorous offset protocols with input from ARB staff, experts, and key stakeholders, and these protocols have encouraged development of a significant amount of high-quality emission reductions both within California and other states. Linking with the Reserve in the context of early action offset credits is a useful first step, as discussed below. Longer-term linkage with the full range of Reserve protocols, however, would generate a significant supply of high quality offsets for the California program.

In addition, CERP urges ARB to evaluate near-term linkage opportunities with other nongovernmental offset programs, for both early action and long-term linkage. While CERP recognizes that protocols developed under these programs would need to meet regulatory requirements set by ARB, we believe that nongovernmental offset programs have developed many high-quality emission reduction protocols that should be eligible for recognition. Therefore, CERP recommends that ARB develop a clear and transparent process for evaluating and adopting protocols approved under other nongovernmental offset programs.

2. REDD

CERP also supports efforts to link with partners within the Governors' Climate Task Force (GCF) and with nongovernmental protocols in order to generate international offset credits from projects that Reduce Emissions from Deforestation and Forest Degradation (REDD). Tropical deforestation is both a significant source of anthropogenic greenhouse gas emissions and a serious threat to tropical forest ecosystems and biodiversity. REDD offset projects can both channel private sector investment into efforts to curb deforestation *and* generate cost-effective emission reductions. CERP strongly urges California to create linkages with GCF partners and nongovernmental protocols to facilitate the development of high quality REDD offset projects as soon as possible. These projects will be an important source of offsets (and therefore cost containment) for the California system and will generate important environmental co-benefits.

3. Clean Development Mechanism

CERP strongly supports ARB's proposed linkage with the Clean Development Mechanism (CDM) in order to bring CDM credits into the California system. Through the CDM, California can access high-quality international offsets from developing countries, which will provide cost-effective emission reductions to the California program and facilitate the transition to low-carbon development around the world.

CERP strongly opposes, however, the ARB staff proposal to be "selective"—on grounds other than environmental integrity—in determining which CDM credits to allow into the California system. If there are genuine issues with the environmental integrity of a CDM project type or a prospective host country, then selectivity would clearly be warranted. ARB could, for example, develop a "negative list" of project types, host countries, or projects that would be ineligible to generate credits that could be used as or exchanged for compliance credits in the California system. However, all CDM offset credits of high environmental integrity should be allowed into the California system. As discussed above, an offset program with broad geographic coverage dramatically increases the efficiency of a cap-and-trade program by capturing the most cost-effective emission reduction opportunities available. By linking to the CDM, California can gain access to these cost-effective emission reduction opportunities and achieve its environmental goals at the least cost to California households and businesses.

B. ARB Offsets

1. Geographic scope

CERP supports ARB's proposal to issue offset credits to offset projects in the United States, Canada, and Mexico. CERP urges ARB to remain open to issuing offset credits

to projects outside of North America in the future should linking with other programs fail to provide a sufficient supply of high integrity offset credits for the California cap-and-trade program.

2. Standardized methodologies

CERP supports ARB's proposal to develop standardized methods for estimating project baselines and determining additionality. Standardized baselines provide for greater objectivity in assessing additionality and are a more efficient means of assessing offset projects.

3. Timing

CERP strongly supports ARB's intention to finalize some offset protocols and begin register offset projects and emission reductions in 2011. This will be critical to providing offset project developers with the guidance they need to begin developing projects to generate compliance grade emission reductions that will be available to regulated entities during the early compliance periods.

4. Additionality

CERP supports ARB's proposal not to apply a financial additionality test to offset projects.

CERP strongly opposes, however, the proposal under consideration to use California's regulatory requirements as the baseline for determining the "regulatory additionality" of projects outside of California. This approach fails to recognize or incentive emission reductions that are *actually additional* in those jurisdictions. Disqualifying these truly additional emission reductions would 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. This would constrict the supply of offsets, and the cost containment they can provide.

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 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. Methane capture projects at landfills are one important project type that can fulfill this objective. By making a diverse portfolio of offset projects eligible to generate compliance offset credits, including project types that can be implemented

in the near term, the California program will ensure a robust supply of environmentally rigorous offset credits.

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 initial 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 buying down the initial costs of installing abatement technologies, thereby making it easier for other jurisdictions simply to require their use.

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.

5. Crediting Periods

(a) Length

CERP supports the establishment of a 10 year crediting period for non-sequestration project types. This would be consistent with the approach taken by the Reserve, and would help drive investment into high quality emission reduction opportunities that take some time to begin generating credits. Most offset projects require a number of years to optimize equipment and iron out any initial operating problems, and therefore the emission reductions credited in years 5 through10 are important for securing investment in offset projects.

(b) Renewals

CERP opposes the proposal to allow projects to apply for only a single renewal of the crediting period. When an offset project applies for a new crediting period, its additionality will be assessed against the then-current protocol. Non-additional projects will not be eligible for a renewed crediting period. Updating of protocols should be the method of taking into account changed circumstances for project types (such as new regulations, or practices that have become business-as-usual). Projects that continue to generate additional emission reductions, however, should

not be arbitrarily cut off after two crediting periods. This would needlessly sacrifice cost effective emission reduction opportunities.

(c) Regulatory Certainty

CERP presumes, although this was not explicitly stated at the workshop, that an offset project will be assessed against the protocol in effect at the time of its initial approval for the duration of the crediting period. Upon applying for a renewed crediting period, a project would then be assessed against the then-current version of the protocol. In order to ensure that they can recoup the investment made in developing a project, project developers and investors need the certainty that the rules that govern the project will remain constant for the duration of the crediting period, and that the project will be shielded from any changes to the relevant offset rules that occur during the crediting period.

6. Start Date

CERP supports ARB's proposal to allow project start dates to vary based upon the requirements of the offset program under which they are registered.

7. Enforcement

There are two separate concerns related to the long-term integrity of verified offset credits. One is the possibility that a sequestration offset project could experience a reversal. The other is the possibility that a verified offset credit could later be found to be ineligible due to an accidental error in measurement or intentional fraudulent activity. These two enforceability issues have distinct causes and should therefore have distinct remedies.

In the context of sequestration projects, CERP urges ARB to adopt a buffer reserve mechanism. Under this framework, a risk-adjusted quantity of credits would be withheld from each sequestration project and placed in the buffer reserve. If a project experienced a reversal, an equivalent number of credits in the buffer reserve would be canceled in order to make the offset program whole. If the reversal was determined to be intentional, the project developer would be liable for replacing the canceled reserve credits with allowances or offset credits.

In the event that a verified, issued offset credit is later found to be ineligible due to error or fraud, CERP advocates placing the liability on the agent responsible for the error or fraudulent activity.

CERP strongly opposes the use of "buyer liability" in either context. A "buyer liability" system would require the entity that submits an offset credit later found to be ineligible to replace that credit. Under a "buyer liability" framework, a regulated entity must assess the long-term risks associated with different types of offset projects. Regulated entities are not generally knowledgeable about the different

types of offset projects or the minutia of their implementation. In this context, two inefficient market responses would occur.

First, regulated entities would severely discount the value of offset credits because they are not well positioned to accurately assess the risks associated with different types of offset projects. Exaggerated risk assessments and the associated devaluation of offset credits would make offsets—often the lowest-cost method of achieving emission reductions—more expensive, increasing overall costs of compliance and the costs of the cap-and-trade program borne by households and businesses.

Second, many offset purchase agreements would likely incorporate some form of "replacement" obligation on the part of the seller. These replacement obligations would make offsets non-uniform and offset credit purchase agreements more complex (and therefore more expensive). If offsets are going to meet their cost containment potential, the market for offset credits should be as liquid and efficient as the market for allowances. This implies that it must be workable for an offset credit to be bought and sold more than once before it is surrendered for compliance.

As a result of the two effects outlined above, offsets would no longer be a highly fungible commodity. Although each offset credit would have been certified by ARB as equivalent to a reduction of 1 ton of CO_2e, offset credits would not be seen as a homogeneous commodity. Rather, each offset credit would have distinct characteristics based on the assessment of its "riskiness" and based on any seller replacement obligation contractually associated with the credit. The purchaser of an offset credit in a secondary market would have to find a way to obtain information about the terms of the contract between the first seller and the first buyer.

The non-uniformity of offset credits would diminish the efficiency of the cap-and-trade program, reducing its ability to foster trading of identical emission reductions (offsets) and emission permissions (allowances) such that the most cost-effective emission reductions opportunities available in the system are captured. A buyer liability system would needlessly reduce the efficiency and increase the costs of the California cap-and-trade program.

CERP is cognizant that the ARB staff members wish to encourage offset buyers to conduct "due diligence" in their offset purchase decisions, and understands the need to ensure that the offset program can be made whole if any credits are determined to be ineligible. As noted above, CERP believes that it is inefficient to ask offset buyers to become experts on the various types of offset projects and to assess any risk of reversal, fraud, or other non-compliant factors associated with specific projects. The locus of control is at the offset project developer. The developers have the greatest knowledge of and control over the factors required to generate qualifying emission reductions, and therefore are in the best position to ensure compliance. The penalty for generating a non-compliant credit, and the incentive to

generate compliant credits and to maintain sequestration, should therefore be applied to offset project developers.

The other entities with specialized knowledge in offset projects and protocol requirements are offset project verifiers and the ARB offset program staff themselves. To the extent that verifiers may be involved in irresponsibly certifying non-compliant credits, they too should be penalized. These three groups—offset developers, verifiers and regulators—can and should be relied upon to ensure the integrity of offset credits.

Any person or entity that sells products or services to persons in California is subject to the California laws—and related enforcement mechanisms—that apply to such activities. Further, all offset project developers (or, at a minimum, each offset project "representative") and verifiers must establish a relationship with the State of California in order to participate in the offsets program. These entities will be registered with and known by the program regulators. The State of California will have the capacity to enforce the integrity of its offsets program by requiring developers and verifiers to replace any offset credits later found to be ineligible due to fraud or some other cause. However, involving offset buyers in due diligence, who lack the specialized knowledge of offset projects, simply creates market inefficiencies and increases overall costs. Offset project developers, verifiers, and regulators are in a much better position to efficiently ensure the integrity of offset credits.

8. Additional Protocols

CERP supports ARB's proposal to develop additional ARB protocols in 2011 for the capture of fugitive emissions from natural gas transmission facilities, waste water sector emission reductions, coal mine methane capture projects, and landfill methane capture projects throughout North America. Further, CERP agrees with the ARB staff members' assessment that methane capture projects at coal mines and landfills outside of California have a large supply potential.

As noted above, ARB estimates that offset credits from ODS destruction projects will supply over 90% of the supply of compliance offset credits through 2020. This extreme dependency upon one project type for supply, and therefore for cost containment, seems to expose the program to a high and unnecessary level of risk. CERP urges ARB to develop or link to a diverse portfolio of offset project protocols in order to ensure a sufficient and robust supply of offset credits for the California program. CERP also recommends that ARB prioritize developing protocols for project types that are capable of generating a large supply of offset credits, and project types for which there are already well-established and tested baseline methodologies.

C. Early Action

CERP strongly supports ARB's efforts to recognize the early actions that have been taken to reduce greenhouse gas emissions. It is important to recognize the early efforts that entities have made to reduce emissions while regulatory emission reductions programs have been developed. Early action offset credits can also be an important source of offset credits during the early years of the California cap-and-trade program, when offset availability is likely to be constrained. ARB's proposal to link to the Reserve protocols for forestry, livestock digesters, and urban forestry to generate early action offset credits on a 1 ton for 1 ton basis is a useful step forward. However, CERP feels that this early action proposal is limited in ways that are unnecessary and will constrain the supply of high integrity offset credits.

First, CERP strongly opposes ARB's proposal to limit early action offset eligibility to credits issued under the three specified Reserve protocols, and to vintages of 2005 or after. The Climate Action Reserve was created by the state of California to encourage early actions to mitigate greenhouse gas emissions. 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. CERP urges ARB to make all of the Reserve protocols eligible to generate early action credits, and to make all credits issued under those protocols eligible for early action. Also, as noted above, CERP recommends that ARB integrate any "linked" programs or protocols into the early action program as well.

Second, CERP is concerned with ARB's proposal to limit the eligibility of Reserve forestry offset credits to those issued under protocol versions 2.1 and 3.0. The Reserve forestry protocol version 3.1 was developed using a two-year expert stakeholder process to address concerns raised by experts and by ARB staff members themselves. Protocol version 3.1 is therefore the current "state of the art" protocol, and is the only Reserve forestry protocol under which forestry projects can currently be registered. The subsequent Reserve forestry protocol, currently under development, will similarly be addressing issues raised by experts and ARB staff members. ARB should allow early action credits generated under forestry protocol version 3.1 (and the subsequent version), developed at the behest of ARB staff members, as well as versions 2.1 and 3.0.

Third, CERP strongly opposes ARB's proposal to limit early offset eligibility to projects located within California. Greenhouse gas emission reductions have an identical effect on the atmosphere regardless of where they are achieved. Offset project opportunities within California are severely limited, and therefore the quantity of offsets that can be generated is similarly limited. In addition, entities across the United States and Canada have been investing in emission reductions in anticipation of legislative and regulatory greenhouse gas abatement developments in California, regional programs such as the Western Climate Initiative, and at the federal level.

CERP agrees with the conclusion reached by ARB staff members that the dormant commerce clause prevents California from discriminating against offset credits generated in other states as that would constitute an excessive restriction on interstate commerce. It is unclear to CERP why the same principle does not apply to early action offset credits generated in other states.

Fourth, CERP urges ARB to give projects registered under an eligible early action protocol a *full 10 year crediting period* during which the project would be eligible to generate early action credits. In order to make offset project development financially viable, offset project developers and investors need an established period of time during which they can generate eligible offset credits under a given set of rules. The current proposal would result in many projects having a very abbreviated crediting project before they must re-submit under new rules. Such conditions would discourage investment in projects.

IV. Conclusion

We appreciate your consideration of our comments, and look forward to working with you to maximize the efficiency and environmental efficacy of the California offset system.

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Appendix A

Members of the Coalition for Emission Reduction Projects

Alpha Natural Resources

American Electric Power

Blue Source

Camco

C-Quest Capital

C-Trade

Deutsche Bank

Dominion

DTE Energy

Duke Energy

Element Markets

El Paso Corporation

Environmental Credit Corp.

Equator, LLC

John Deere

Leaf Clean Energy Company

Natsource

Noble Carbon Credits

PG&E Corporation

Verdeo Group

Appendix B

CERP Statement of Principles

The mission of the Coalition for Emission Reduction Projects (CERP) is to educate policy-makers and the general public about the benefits of using offset allowances from domestic and international greenhouse gas (GHG) emission reduction projects as a means for regulated entities to meet their compliance obligations under any U.S. GHG cap-and-trade program.

CERP believes that any U.S. GHG regulatory program should adhere to the following principles:

1. Entities regulated under any U.S. cap-and-trade program should have the ability to achieve their compliance obligations through the use of offset allowances from qualifying emission reduction projects.

Regulated entities should have the flexibility to help meet their compliance obligations by using emission reductions from projects that are not otherwise subject to the emissions cap. Multiple studies have shown that allowing use of such offset allowances can: (1) lower costs of compliance for regulated entities and costs of GHG regulation for society as a whole; (2) create greater incentives for development and deployment of emission reduction technologies; and (3) achieve emissions reductions from sources that would not otherwise occur.

2. Offset allowances should be available only for projects that achieve emission reductions that are additional, permanent, independently verified, enforceable, and measurable.

Any U.S cap-and-trade program should include clear and rigorous rules for approval of projects and issuance of offset allowances. A credible authority should oversee administration of the offset program, with support from independent accredited third-party verifiers.

3. The project approval process should be transparent and rely on established, approved project types and methodologies, with clear procedures to approve new methodologies and project types.

The project approval process should achieve three objectives: (1) ensuring environmental integrity; (2) controlling administrative and transaction costs; and (3) providing for investment certainty as early as possible. Adoption of pre-approved methodologies and a preferred list of project types eligible for streamlined approvals will reduce compliance costs and investment risks, thus encouraging greater market participation. Similarly, a streamlined and transparent process for approval of new methodologies will provide necessary incentives for the development and deployment of new technologies.

4. Offset allowances should be available from an expansive set of sectors, activities, and countries.

Any U.S. emissions reduction program should focus on environmental integrity of projects and their compliance with the relevant standards created by the program. All project types that are not otherwise subject to emissions limits and that can comply with the applicable standards should be eligible.

5. Any U.S. GHG regulatory program should allow for the use of offset allowances from international projects.

Climate change is a global environmental issue. As such, geographic location should not limit the ability of a project to qualify under a GHG regulatory program. Indeed, many low cost opportunities for reducing emissions are in developing countries. Accordingly, allowing for the use of reductions from such countries not only will lower the costs of compliance with the U.S. program, it will provide a means of transferring U.S. clean energy technologies and expertise to the developing world. Importantly, allowing use of international offset allowances for compliance purposes provides an opportunity for the U.S. to demonstrate its leadership on the issue of climate change and to engage with the global community in reducing emissions.

6. Entities that implement emission reduction projects prior to the establishment of a U.S. regulatory program, and that meet the applicable standards for project eligibility, should be awarded offset credits.

Entities (not just those subject to emissions limits) that implement otherwise-qualifying projects should be provided offset credits for reductions achieved by those projects prior to enactment of GHG regulatory legislation.