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Ms. Lucille Van Ommering
California Air Resources Board
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Re: First Climate LLC Comments on Implementing a Quantitative Limit on the Use of Offsets in a Cap-and-Trade Program

Dear Ms. Van Ommering,

First Climate appreciates the opportunity to offer the following comments to the California Air Resources Board (CARB) regarding implementing a quantitative limit on the use of offsets in a cap-and-trade program. We appreciate CARB's efforts to gather public comment on this topic and offer the following comments and recommendations based on our extensive experience in international and US carbon markets.

As US climate policy discussions and regional rulemaking processes continue to move forward, key policy decision makers consistently tout the value of incorporating greenhouse gas (GHG) offsets into mandatory cap-and-trade schemes. Both the international compliance and voluntary carbon markets have showcased the many benefits of strategic offset incorporation to meet near term emission reduction goals. Offsets enable capped entities and consumers to benefit from the speed and agility with which the private sector has moved in these markets to create innovative solutions to reduce emissions from un-capped sources.

Within a regional or national US cap-and-trade scheme, it is imperative that the inclusion of both domestic and international offsets be structured to permit the use of only high quality offsets that create real, verifiable and additional emission reductions, and we commend the CARB for incorporating these principles in its design of an offsets scheme. Furthermore, limits on offset use within a cap-and-trade scheme should prioritize incentivizing internal, domestic reductions from capped sources while also realizing the full cost-containment potential that offsets can provide. The environmental integrity of the offset projects that are accepted should meet stringent guidelines that ensure that the many co-benefits derived from the development of these projects be realized along with the valuable emission reductions.

Offsets should complement a cap-and-trade scheme by providing carbon cost-containment, socio-economic benefits, job creation, clean energy production and incentives for new and

innovative sustainable infrastructure development. This complementary role is especially essential in the early years of a cap-and-trade program as a transitional tool that enables capped entities to drastically lower overall compliance costs.

The cost-containment function of international offsets has been proven effective in the EU-ETS as, for the majority of Phase 1 and 2, primary CERs have been trading at a considerable discount to EUAs, and while the discount between secondary CERs and EUAs has narrowed, issued CERs still trade at a discount to EUAs. There are multiple examples of new and innovative emissions reduction projects that have been realized through the Clean Development Mechanism (CDM), and these projects and methodologies can serve as a blueprint for the US in developing offset criteria. Additionally, legislation for Phase 3 of the EU-ETS envisions the possibility of including domestic offsets in addition to international projects. While much has yet to be determined regarding the use of domestic offsets, it's important to note that the value of their incorporation is highly anticipated.

Benefits of Offsets Under AB 32

We support the requirement under AB 32 that the reductions from offsets must be real, additional, quantifiable, permanent, verifiable and enforceable (H&S Code §38562(d)). Additionally, we want to applaud the following short list of benefits that CARB noted would be achieved by including offsets in the California cap-and-trade scheme:

Cost-containment

Mitigating the cost of meeting emission reduction requirements for capped entities is one of the key benefits of incorporating offsets into a cap-and-trade scheme. Allowing capped sources to meet a portion of their emission reduction requirements through the use of offsets would allow these entities to take advantage of the lowest cost reductions available and would therefore mitigate compliance costs for capped entities and, indirectly, mitigate and/or minimize additional costs that would have been passed on to consumers.

Temporal considerations

Achieving on-site emission reductions is often a lengthy and costly process for capped entities depending upon the extent of early action taken to implement emission reduction measures. Offset projects can often come online and achieve emission reductions sooner than other forms of reductions and therefore can greatly contribute to capped entities ability to meet emission reduction targets within early compliance periods.

Target sources and sinks of emissions that are difficult to include directly in the cap

Although the Scoping Plan for AB 32 sets a stringent cap on large industrial and electricity providers in the first compliance period, even a wide-ranging cap-and-trade program cannot address all sources of GHG emissions. Incorporating offsets into California's cap-and-trade scheme creates opportunities to incentivize emission reductions for sources and sinks outside of the cap at the individual project level.

While this list outlines key benefits achieved through the incorporation of offsets under a cap-and-trade scheme, **it's important to note multiple additional benefits that have been illustrated through the use of offsets:**

Co-Benefits:

Socio-economic benefits derived through the development of GHG offset projects in developing countries are one of the primary reasons behind the deployment of the Kyoto Protocol's Clean Development Mechanism (CDM). Under the CDM, Certified Emission Reductions (CERs) are created, verified, bought and sold to meet emission reduction targets. These projects have resulted in socio-economic benefits ranging from technology transfer to job development and local economic development.

Political Capital:

If capped entities know that they will be able to meet a portion of their emission reduction requirements through the use of lower-cost options like offsets, it may lead to the acceptance of higher early emission reduction goals. Capped entities are more likely to accept more stringent reduction targets if they can ensure they will not be able to meet them cost effectively in early years while they work to incorporate internal emission reduction measures. As a result, the necessarily stringent emission reduction targets that need to be met in early years to avoid the catastrophic effects of climate change become much more viable, both politically and economically.

Sustainable Infrastructure Development:

There are currently over 100 different project methodologies approved by the CDM Executive Board (EB), all of which meet high environmental and socio-economic standards. While this approval process has not been without criticism or conflict, California should adopt similar high standards for both domestic and international offset projects to encourage technology and knowledge transfer between states and countries. California and the US can also benefit by lessons learned within the CDM and can work to devise a project approval process that reflects these high standards while fast-tracking sustainable infrastructure development.

Environmental Innovation

GHG offset project development presents a valuable opportunity to address emissions from small sources not easily monitored under a larger cap-and-trade program. While smaller in size, these sources do add significantly to our overall emissions and, without a cap, will remain unregulated with the potential to grow and increase their negative contribution. We should take every reasonable opportunity to incentivize environmental innovation to meet aggressive emission reduction goals while strengthening our ability to transition to a clean energy economy.

Offset Limit Structure Under AB 32

The AB 32 Scoping Plan states that offsets cannot meet more than 49 percent of the overall program emission reduction goals. Effectively incorporated, offsets should provide the above listed benefits while enabling capped entities to meet GHG emission reduction goals at the lowest cost to both their stakeholders and consumers. Incorporation of offsets is a rational transitional strategy, one that enables a carbon intensive society to transition to a low-carbon economy while incentivizing environmental innovation and stimulating sustainable infrastructure development and green collar job creation.

Therefore, within most cap-and-trade programs currently in development or existence, offset use is limited quantitatively as a way to ensure that domestic, internal reductions at capped emission sources are achieved in conjunction with the development of emission reduction projects outside the cap. There is concern that offset inclusion will contain carbon prices to the extent that incentives to make the technological change needed to address climate change will be eliminated and GHG reduction goals will not be met. While this is a very real concern, setting an effective limit on the use of offsets can correctly define them as a transitional but environmentally and economically effective tool and can ensure that the multiple benefits derived, including cost-containment, are realized. This limit must be large enough to achieve full cost-containment potential and address temporal considerations and small enough to ensure that internal emission reduction measures are also incentivized.

To address CARB's questions concerning offset limit structure, First Climate would like to offer the following comments based on our international experience. Within the EU-ETS, there is currently a "usage" limit on offsets that designates a certain percentage limit on the amount of offsets a covered entity can use to meet their compliance obligation. This system works well for the following reasons:

- 1) Increases market certainty and effectively contains costs as capped entities know exactly how many offsets they will be able to use to meet compliance obligations.

- 2) Enables market trading activity to increase as it creates the potential for offset/allowance swaps for companies that do not use their entire offset quota.
- 3) Incentivizes capped entities to invest heavily in internal reductions as they have a very clear limit on the amount of cost-effective offsets that they can use to meet their reduction obligations.

Based on this experience, we would support a “usage” limit over a “supply” limit on offsets within the 49 percent limit overall. We feel that a usage limit not only allows entities to take full advantage of the cost containment benefit of offsets but also creates a much more certain landscape for project developers while a supply limit would create overall market uncertainty and therefore may de-incentivize much needed domestic and international project origination and development.

In conclusion, we recommend that CARB look to the experience of the EU-ETS and voluntary carbon markets to ensure that the inclusion of offsets in a California cap-and-trade scheme is strategic and effective. The many benefits derived through the use of offsets should be prioritized and incentivized to tackle both environmental and economic concerns. In the US, we have the valuable benefit of learning from past Phases of the EU-ETS and the ability to ensure that limits on offsets effectively contain carbon reduction costs while mandating the achievement of simultaneous domestic internal reductions. The many socio-economic and environmental benefits derived from various types of offsets, above and beyond cost-containment, should play an important role in California’s transition to a low carbon economy.

Thank you for your consideration of our comments; we look forward to continuing to participate in this important rulemaking process.

Sincerely,

Aleka Seville
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