

Comments of Morgan Stanley Capital Group Inc.
Criteria for Compliance Offsets
In a Cap-and-Trade Program
May 21, 2009

Morgan Stanley Capital Group Inc. (MSCG) appreciates the opportunity to comment on the California Air Resources Board's draft criteria for a Compliance Offset Program, as described in presentation materials developed for a public meeting held on April 28. Unfortunately, due to the schedule change from the originally scheduled date of April 21, we were not able to attend in person, so our comments are based solely on the presentation materials available on the web site, and are not informed by any discussion or clarification that may have taken place at the meeting. If there is any desire for follow-up communication, please contact Steve Huhman, Vice President, at (914) 225-1592, or via e-mail at Steven.Huhman@morganstanley.com.

Broadly speaking, MSCG believes that the program outlined in the presentation is a sound and robust program that we can enthusiastically support. Adoption will complement and greatly increase the odds of success of the overall Cap-and-Trade program. We do, however, have comments on three specific areas which we believe will lead to improving the overall offsets program.

First, MSCG is not supportive of the concept of limiting the use of offsets to 49% of the desired emission reductions. We have always been supporters of holding offsets to very high standards to ensure their environmental integrity. However, once such high standards are met, there is no justification for limiting the use of such offsets. Either the reduction represented by the offset is real, and therefore just as valuable in mitigating climate change as a reduction from a "covered" source, or the reduction is not, in which case it should not be utilized at all.

Restricting the use of otherwise qualified, high-quality offsets will increase the cost of emissions reductions for California consumers and businesses, with no concomitant benefit in incremental reductions of greenhouse gas emissions. In fact, given the proclivity of most high-quality offset certification protocols to err on the side of conservatism, restricting the use of high-quality offsets may in fact be counterproductive in terms of climate impact. This could be so if the actual reductions achieved by a project exceed the nominal amount implied by the number of credits granted, due to the conservatism factor. Under that scenario, use of an offset credit would actually achieve greater reductions than would use of an allowance.

The long-run success, and ongoing continuation of a greenhouse gas reduction program is contingent on continued public support, and such support is contingent on the costs being perceived as tolerable. For this reason, every opportunity to achieve the desired environmental result at the least possible cost should be fully embraced. Therefore, no restrictions on the use of qualified offsets should be imposed.

Second, MSCG does not believe that any type of entity should be restricted in its ability to own or transact in offset credits. As with any market, maximizing the number of participants also maximizes liquidity, and minimizes the ability of any entity or class of

entities to exercise market power or manipulate the market. Intermediaries will provide services for both project developers and entities with compliance obligations, as, generally speaking, neither will have the expertise or contacts to locate the other. Even if formal exchanges for offsets are somehow established, the use of these exchanges will prove problematic for many who need to transact, as likely registration and financial capability requirements will simply not be worthwhile for small players.

Third, the presentation says that ARB “would not approve offset projects for reductions in developed countries from sources that within California are covered by the cap-and-trade program”. The language “would not approve” is a bit ambiguous, in that, taken literally, it would mean that ARB would not review and approve projects from the described sectors, but does not preclude acceptance for compliance purposes of credits created by such projects if approved by another recognized agency. If the literal interpretation is all that is intended, then MSCG has no further comment. However, if, due to the shorthand required for a “bullet point” presentation, the full intent is to not accept such credits for satisfaction of compliance obligations, even if issued by other systems, then we do not see the logic. Essentially, the same rationale applies as described above in our discussion of offset limits generally. If the reduction is real, exclusion of such offsets neither helps the climate nor minimizes societal costs. For those reasons, we do not believe a supportable case can be made to exclude such offsets.