Wednesday, December 15, 2010

Chairman Mary Nichols
Air Resources Board, California Environmental Protection Agency
1001 I Street
Sacramento, CA 95812

RE: Forest Carbon Offsets in Proposed Regulation Order

Dear Chairman Nichols:

Thank you for the opportunity to comment on the forthcoming cap and trade program under AB32.

New Forests manages approximately $700 million in investments in sustainable forestry and associated eco products, such as carbon, biodiversity and water, for institutional and private equity clients. The company is headquartered in Sydney, Australia, with offices in San Francisco and Kota Kinabalu, Malaysia. New Forests has been active as a company in forest carbon markets for five years: New Forests' staff participated in the committee that developed an early version of the CAR forestry protocol, contributed to the Voluntary Carbon Standard's AFOLU guidelines, contributed to the development of the New South Wales Greenhouse Gas Abatement Scheme, participated in the stakeholder working group that assisted CAR with the development of its proposed aggregation guidelines, and currently participate in the ANSI-accredited Forest Carbon Standards Committee and the CAR Mexico Forest Project Protocol committee. New Forests' joint venture investment vehicle, the Eco Products Fund, has invested actively in forest carbon projects for the California market.

The practical experience in project development and offset project investment that informs our comments and suggestions may prove useful to staff as they finalize the regulations for the future offset program. Thank you for considering our comments, which we have attached to this cover letter.

Sincerely,

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General

Incorporate Aggregation Rules into the U.S. Forest Projects Protocol

The staff report for the Compliance Offset Protocol for U.S. Forest Projects (the "Compliance Forest Protocol") highlights that ARB staff decided not to include aggregation rules for smaller forest owners in the protocol at this time, in part due to time constraints related to evaluating the aggregation rules that were very recent adopted by the Climate Action Reserve in August 2010. ARB staff noted that they recognize the significant potential benefits for the environment and offset supply of lowering barriers to participation for small forest owners.

We commend ARB staff's focus on the barriers to participation facing smaller forest owners, and we would encourage ARB to incorporate aggregation rules into the compliance Forest Offset Protocol in 2011. Approximately 75% of all private forest acreage in the U.S. is held in ownerships of under 5,000 acres. Family forest owners often maintain forests that have higher carbon stocks and older growth stands than industrial forest owners. These older growth forests are at significant risk of harvest and conversion due to financial pressures and estate planning problems faced by the families that own and manage them. At the same time, family forest owners face high upfront costs in developing carbon offset projects and a difficulty in marketing small lots of offsets. Aggregation makes carbon projects feasible for family forest owners by helping them achieve economies of scale while maintaining high standards for carbon measurement and offset quality.

Enabling aggregation will be critical to delivering offset supply from U.S. forests and to ensuring that the carbon markets are not accessible only to large industrial forest owners. In our view, the Aggregation Guidelines adopted by CAR in August 2010 do not conflict with any provision of the compliance U.S. Forest Projects Protocol, and incorporating a version of the CAR aggregation model would level the playing field for family forest owners, help protect older-growth forests managed by families, and provide a significant boost to forest carbon offset supply. We hope that developing aggregation rules will be a priority for ARB staff in 2011.

Develop a pathway for sector-based REDD crediting in time for the first compliance period.

We strongly support the inclusion of sector-based credits from Reducing Emissions from Deforestation and Forest Degradation (REDD) in California's cap and trade system. We commend the California Air Resources Board's (ARB) expressed intent in its final draft regulations to link with international REDD programs. ARB's groundbreaking efforts to create a sectoral REDD crediting mechanism will spur action to address a major source of global greenhouse gas emissions and promote significant forest conservation and sustainable development outcomes. Moreover, the rapid and comprehensive development of a REDD crediting pathway is vitally important to ensure adequate offset supply and cost containment of greenhouse gas reductions, especially during the first compliance period.

New Forests joined a joint statement with a number of environmental organizations, regulated entities and forest carbon project developers, which expresses shared recommendations on REDD at this time.

Addressing Reversals

§95983(e)(1): Intentional reversals that leave carbon stocks above a project's baseline should not automatically trigger project termination, and conflicting language in the proposed regulation and the U.S. Forest Project compliance protocol should be reconciled on this issue.

The Compliance Forest Protocol, like the CAR Forest Project Protocol v3.2, requires intentional reversals to be replaced with offset credits at a certain rate that are then retired but does not require the termination of that project following an intentional reversal so long as the project's carbon stocks remain above baseline. Section 7.4 of the Compliance Forest Protocol states that "If a reversal lowers the Forest Project's actual standing live carbon stocks below its approved baseline standing live carbon stocks, the Forest Project will automatically be terminated" but makes no other provision for automatic termination (60). The PRO, in contrast, states in §95983(e)(1) that "If ARB determines that an intentional reversal has occurred pursuant to section 95983(c), the forest offset project will automatically be terminated by ARB or an Offset Project Registry." We recommend that this language be revised to align with the language in the Compliance Forest Protocol as follows:

> §95983(e)(1) "If ARB determines that an intentional reversal has occurred pursuant to section 95983(c) **and such intentional reversal lowers the Project's actual standing live carbon stocks below its approved baseline standing live carbon stocks**, the forest offset project will automatically be terminated by ARB or an Offset Project Registry.

Imposing an automatic project termination due to any intentional reversal makes little sense from an atmospheric integrity perspective and would impose unbearable financial risks on the shoulders of forest owners. Consider a forest owner with an Improved Forest Management project who accidentally removes an extra 1 tonne from the obligated reductions on the project area, which would constitute a minor intentional reversal. Under the current PRO §95983(e)(1) language, such a minor intention reversal would cause the entire project to be automatically terminated, forcing the landowner to go to the market to replace a large volume of offsets within 30 days at current market prices as required under §95985(e) – all for carbon that has not actually been emitted into the atmosphere. Because many landowners do have ready access to the large amount of liquid capital it would take to replace a large volume of offsets in 30 days, complying with the PRO as written in the event of a minor intentional reversal would likely lead to the liquidation of the forest to pay the liability – an outcome contrary to the purpose of AB32.

From the perspective of atmospheric integrity, all that is necessary in the event of an intentional reversal that does not reduce carbon stocks below the project baseline is to replace and retire the tonnes reversed. If 5 tonnes or 1,000 tonnes of obligated reductions have been intentionally emitted, 5 tonnes or 1,000 should be replaced and retired. Requiring forest projects to be terminated due to any intentional reversal is unnecessary for the climate, and the financial risk would severely reduce the number of landowners willing to enter into forest carbon offset projects.

§95985(e): An intentional reversal should only trigger a requirement for the replacement of each metric tonne reversed.

This section contains some ambiguity as to whether it is only the reversed volume of CO2e that must be replaced or the obligated reductions of the entire project. For the reasons outlined above, we would recommend that §95985(e) be clarified as follows:

§95985(e) "If an intentional reversal occurs from a forest offset project, the Offset Project Operator or Authorized Project Designee must ~~replace~~ **retire a volume of approved compliance instruments pursuant to subarticle 4 equivalent to the volume of metric tonne of CO2e reversed** ~~pursuant to subarticle 4~~, within 30 calendar days of being notified by ARB."

§95985: "Replace" should be a defined term.
§95985 makes extensive reference to the concept of replacing credits in the event of a reversal, but the term is not defined. "Replace" should be a defined term, perhaps defined as transferring a compliance instrument into the Retirement Account established pursuant to §95831(3).

§95983(e)(3) and §95985: Intentional reversals should be remedied by the Forest Owner but not cause the invalidation of transacted offset credits and the removal of such credits from any Holding or Compliance account. Buyer liability should only be imposed for fraud or significant errors in the system.
The drafting of these sections is somewhat ambiguous and would appear to require both the replacement of reversed tonnes and the cancellation of transacted credits in the event of a reversal from a forest carbon offset project. As a general principle, a reversal of an obligated reduction should be compensated for in the system once to ensure atmospheric integrity, but the proposed system would require a reversal to be compensated for twice.

Consider the following scenario: a landowner sells an offset credit representing 1 tCO2e to an entity with compliance obligations under AB32. That landowner's project then suffers an intentional reversal of 1 tCO2e. ARB exercises its discretion to determine that the offset credit sold is invalid pursuant to §95983(e)(3) and §95985(b)(1).[1] The offset credit in the compliance buyer's Holding or Compliance account is therefore cancelled and removed by ARB pursuant to §95985(c).[2] As required by §95985(e),[3] the Offset Project Operator or Authorized Project Designee must replace the 1 tCO2e, and they do so by purchasing an offset or other compliance instrument and retiring it. In this scenario, two compliance instruments have been canceled or retired to compensate for the reversal of one compliance instrument by the forest owner – the original offset canceled pursuant to §95985(c), and the compliance instrument purchased and retired pursuant to §95985(e). If the reversal is adequately compensated through the forest owner purchasing and retiring a compliance instrument pursuant to §95985(e), and there is therefore a net zero emission to the atmosphere, why also cancel the transacted credit?

We would recommend that buyer liability apply only for significant errors or fraud in the system pursuant to §95985(b)(2), and that intentional and unintentional reversals from forest carbon offset projects be addressed solely through §95985(e) and (f), which fully maintain atmospheric integrity. The following changes to §95985 would accomplish this:

[1] §95983(e)(3) provides that "Offset credits issued to an offset project that suffers an intentional reversal may be determined to be invalid pursuant to section 95985." §95985(b)(1) states that "a finding pursuant to section 95983 that a reversal occurred in a forest sequestration project" may (at ARB discretion) lead to the determination that offset credits are invalid. Note that no criteria is specified to guide ARB in distinguishing between forest sequestration reversals that will lead to credit invalidation and those reversals that will not – ARB's discretion is unconstrained in this matter.
[2] §95985(c) states that "If ARB determines that an offset credit it issued is invalid pursuant to this section . . . the offset credit will be cancelled and removed from any Holding or Compliance account or the ARB Forest Buffer Account".
[3] Assuming the intention in 95985(e) is not to require the replacement of the entire project's credits, only those reversed.

§95985(b) "An offset credit may be determined to be invalid for the following reasons: ~~(1) a finding pursuant to section 95983 that a reversal occurred in a forest sequestration project; or (2)~~ **(1)** ARB has determined that errors . . . warrant a reversal."

§95985(d) "If an offset credit found to be invalid pursuant to ~~this~~ section **95985(b) above**~~, except as provided in section 95985(e) and (f),~~ has been retired . . ."

§95985(e) "If an intentional reversal occurs from a forest offset project . . . within 30 calendar days of being notified by ARB. If the Offset Project Operator or Authorized Project Designee does not replace the ~~invalid~~ **reversed** offset credit**(s)** . . . will constitute a violation."

§95985(f) "If an unintentional reversal occurs from a forest offset project, ARB will retire offset credits in the amount of tons reversed from the Forest Buffer Account. ~~All other invalidated offset credits must be replaced pursuant to section 95985(d).~~" [*this last sentence is redundant and with the changes to 95985(b) above an unintentional reversal will not trigger an invalidation of credits*].

These changes would enable ARB to cancel a credit for significant errors or fraud in the system, and to require forest owners or authorized designees to replace intentionally reversed credits, while avoiding the requirement of an unnecessary double cancellation of compliance instruments solely in the instance of forest carbon offset reversal.

If ARB decides to continue to require the cancellation of transacted offset credits due to a landowner's reversal – in addition to requiring the landowner to make the system whole – compliance buyers will a) avoid forest carbon offsets; b) discount forest carbon offset prices if they must purchase forest carbon offsets; and c) impose liability for replacing any cancelled credits contractually on the forest owner or authorized designee, thereby placing a forest owner in a situation in which he or she must purchase two compliance instruments for every one tonne reversed. In such circumstances few forest owners will seek to supply the market.

Transferring Early Action Credits into the Compliance System

§95990(d): Both ARB and the approved third-party offset program are required to track an offset after the credit is approved by ARB. This should not impose multiple transaction fees on offset purchasers and sellers. This section requires both ARB and the approved third-party program to "track the transactions of offset credits until ARB retires" such credits. As all third-party registries will likely impose transfer fees for offset transactions, we would recommend that ARB clarify that a project will only be charged transfer fees by one registry for early action credits that have been transitioned into compliance credits by ARB.

§95990(c): Requirements for approval of third-party offset programs should include a requirement to relinquish any reversal liability requirements over third-party offsets approved by ARB for compliance use.
Offset sellers that transfer early action credits into the compliance system will need a clear indication of which program they have a liability towards in the event of a reversal. If an approved third-party offset program still tracks offset transactions after the approval by ARB of credits pursuant to §95990(d), it is unclear from the PRO as drafted whether a landowner would (for example) still be subject to the requirements of the Project Implementation Agreement required by the Climate Action Reserve, and would therefore legally face a double liability in favor of both CAR and ARB in the event of a reversal. We would suggest that ARB add a requirement to §95990(c) that offset programs relinquish any contractual right to require an action of the forest owner in the event of a forest carbon reversal that affects tonnes approved by ARB for use in the compliance system.

§95990(f): We recommend that ARB consider a single re-verification process through which early-action projects could be verified as projects under the Compliance Forest Protocol. Valid existing third-party credits from such projects would be exchanged for ARB compliance offset credits and the projects would thereafter be issued ARB offset credits.
We strongly support ARB's interest in accurate measurement, reporting and verification (MRV) of offset projects, but in general we feel that the approach outlined in §95990(f) could be streamlined without sacrificing MRV accuracy or confidence in offset quality. We would suggest that ARB require regulatory verification of projects for early action through a single re-verification of the project, which would transition all eligible credits from that project into ARB compliance offset credits and would enable that project to be registered as a project with ARB and thereafter issued ARB compliance offset credits. This re-verification should not require an additional site visit if a site visit has been performed by an ARB-accredited verification body to the standards of §95977 within two years prior to said re-verification. The project would be de-listed from the third-party registry and listed with ARB or an ARB-approved registry as a compliance-grade project, approved serialized offset credits would be retired and new ARB compliance offset credits issued in their place, and the project would thereafter be issued ARB compliance offset credits pursuant to the ARB Compliance Forest Protocol. Such a system would maintain high standards for measurement, reporting and verification and a high degree of confidence in offset quality while avoiding the unnecessary multiple site verifications currently required in §95990(f).

§95990(f): In the alternative, we would recommend not requiring an additional site visit as a part of the regulatory verification if an ARB-accredited verification body has conducted a site visit of that sequestration project to the standards of §95977 within two years prior to the regulatory verification. Subsequent vintages issued to that project should be issued ARB offset credits following a desk verification of offset data reports.
§95990(f)(3)(A) requires the verifier to conduct a site visit as per §95977(e)(2)(C)(iv) in order to verify the offset project and serialized offset credits that will potentially be issued ARB offset credits. Because this section requires the verifier to perform all of the offset verification services in section 95977 "for each offset data report for each year of the offset credits issued by the third-party offset program" (§95990(f)(3)), the requirement of a site visit would also apply to subsequent vintages as this section is currently drafted. If an early action project seeks verification for 2005-2012 vintages in 2012, and then later seeks to separately re-verify vintages 2013 and 2014 under §95990(f), an additional two site visits would be required. Thus four site visits could be required in three years for an early action forest carbon project – once to be verified with a third-party registry like CAR in 2011, once to re-verify the project with ARB in 2011 or 2012, and twice in the following two years to verify 2013 and 2014 vintages.

This would seem to require somewhat more site visits than truly necessary for confidence in MRV. New Forests has found that the cost of site visits in forest carbon project verification can be an order of magnitude higher than a desk verification of an offset project data report. Faced with the high cost of multiple site visit verifications, many forest owners would choose to delay re-verification with ARB until they were issued all relevant early-action vintages or delay registration with a third-party registry and look to the full compliance program, in either case delaying the availability and curtailing supply of offset credits.

Because the "facts on the ground" do not ordinarily change materially from year to year, the Climate Action Reserve v3.x protocols struck a sound balance between site visit verification and desk verifications. We would urge ARB to adopt an approach to site verification similar to that taken by CAR and would recommend the following amendments to §95990(f):

> §95990(f)(e)(A): "If the offset project is still in operation, the verification body must conduct a site visit as required in section 95977(e)(2)(C)(iv), **unless the offset project has received a site visit by an ARB-accredited verification body to the standards of §95977 within two years prior to the regulatory verification of offset credits for early action pursuant to this section. Verifications of serialized offset credits issued after the first verification of the offset project under this section shall not require a site visit as required in section 95977(e)(2)(C)(iv) if the project has been verified pursuant to this section within six years prior to the verification of the serialized offset credits in question**."

Verification of Projects under the Compliance Forest Protocol

§95977(c) and §95977(e)(2)(C)(iv): Site visits by verifiers should only be required of sequestration projects once every six years, as conditions on the ground do not change significantly from year to year, and ARB has adequate remedies in the event of any reversal. Requiring annual site visits is unnecessary to ensure offset quality and will significantly increase the cost of forest carbon offsets.

§95977(c) makes no distinction between site visit verifications and desk review verifications in requiring the verification of sequestration projects to be performed "at least once every six years and may cover up to six years of GHG reductions or GHG removal enhancements". §95977(e)(2)(C)(iv) requires that "[f]or a forest or urban forest offset project, at least one accredited offset verifier in the offset verification team, including the project specialist, must make a site visit every year that offset verification services are provided. A site visit is also required after the first full calendar year of operations of an offset project."

As noted above, New Forests has found that site visit verifications can be an order of magnitude more costly than a desk verification of data. Forests grow slowly and in most circumstances there will be little change to a given site from year to year. ARB has adequate remedies in the event of a forest carbon reversal: if a forest landowner or offset project developer has engaged in fraudulent activity or made intentional material misstatements in an offset project data report, ARB will be able to impose significant economic sanctions under the proposed regulations and the State of California will be able to pursue jail time for the perpetrators due to perjury. Such penalties coupled with periodic site visits are sufficient to ensure MRV accuracy and offset quality. Requiring annual site visits is unnecessary to ensure offset quality and will significantly increase the cost of forest carbon offsets, making many projects uneconomic – particularly projects on non-industrial forest lands.

We would recommend that ARB require a site visit once every six years for stand-alone forest carbon projects. A desk verification of an offset project data report should be required for issuance of compliance offset credits in the interim.

§95976(d)(6) and §95977(d): To avoid artificially inflating the cost of verification and of offsets, we recommend that ARB allow offset project data reports to be submitted at any time within one year of the relevant vintage year, with offset verification statements due six months after the submission of an offset project data report.

Requiring all offset project data reports to be submitted by April 1 and all offset verification statements to be received by ARB by October 1 of the same year will concentrate demand for scarce verification services in the six month time period between April and October, driving up the cost of verification and therefore the cost of offsets. By permitting offset project data reports to be submitted within one year of the relevant vintage year, with offset verification statements due six months after the submission of the data report, ARB will smooth demand for verification services over time and avoid artificially inflating the cost of verification and offsets. This will also smooth workflow for ARB throughout the year.

Offset Project Reporting

§95976(e): Prohibiting issuance of all offsets credits reported in an Offset Project Data Report due to the report being one day late is not reasonable – we would recommend graduated sanctions.

Delivering an offset project data report will involve coordination and cooperation between the landowner and multiple consultants, and the report could be late for multiple reasons outside of an Offset Project Operator or Authorized Project Designee's control. We would recommend a graduated sanctions approach if it is necessary to impose sanctions for late reports, with a higher percentage of credits being deducted for each one month period a given report is late.

Registries and Credit Issuance

§95990(c)(2)(C): Third-Party Offset Programs should not be required to track prices for offset transactions to be approved by ARB.

Third-party offset programs that may apply to ARB under this section do not, as a general rule, track pricing information in offset transactions. They do not function as exchanges (such as NYSE) and are not regulated as such by the SEC; rather, their registry function tracks ownership of particular offset credits. In addition, there are practical problems associated with tracking prices of over the counter trades, which can take a myriad of forms. We would recommend deleting the last clause ("including prices and counter-parties") in this section.

Definitions

§95802(75): "Forest owner" should be defined to exclude the fee owner when all timber rights are held in perpetuity by another entity.

If one entity holds timber rights in perpetuity on a property and the fee holder has no control over the management of the timber, it would not seem reasonable to define both the fee holder and the timber rights holder as the "forest owner" collectively as currently drafted.

We would recommend amending the third sentence in this paragraph to read "In some cases, one entity may be the owner in fee while another entity may have an interest in the trees or the timber on the property, in which case all entities or individuals with interest in the property are collectively considered the forest owners,

unless the owner of the interest in the trees or the timber on the property owns that right in perpetuity and may manage said timber in its sole discretion."

Errata

§95990(c): The reference to section 959869(d) in this section appears to be a misplaced reference.