May 2, 2011

Via Electronic Mail

Mary D. Nichols
Chairman
California Air Resources Board
1001 I Street
Sacramento, CA 95812
(mnichols@arb.ca.gov)

Re: <u>Handling the Invalidation of Offset Credits in the Cap-and-Trade Regulations</u>

Dear Chairman Nichols:

The undersigned organizations participating in this letter collectively represent a substantial segment of companies that will be participating in the cap-and-trade program that the California Air Resources Board ("ARB") is establishing under AB 32. We greatly appreciate the hard work of ARB staff and leadership in this area.

We recognize the important role that offset projects will play in the regulatory program. Several studies have shown that offsets are central to managing the costs of meeting the AB 32 emission limits. Allowing compliance entities to use some amount of offset credits for compliance also encourages investment in low-cost emission reductions. Offset projects provide a means of encouraging farmers, forest owners, and others to contribute to providing climate change solutions.

We have identified a key design issue with the offset regulations that we want to bring to your attention — and urge you to consider an alternative design that we have collectively developed. This alternative design is detailed in the enclosed "white paper."

The issue is how to address circumstances in which ARB determines — after issuing an offset credit — that the documentation it relied upon for issuing the credit was not true, accurate, or complete. While we believe that the likelihood of such a scenario is very small due to the rigor of ARB's offset regulations, we take it very seriously because it goes to the environmental integrity of the program. The challenge is to devise a policy response that is the most fail-safe and efficient way to ensure that the program is "made whole" in such circumstances.

ARB's current Cap-and-Trade Regulations address this situation through a "buyer liability" approach — *i.e.*, by requiring the holder or user of the flawed offset credit to replace it, even if that holder or user was not responsible for the discrepancy, and even if the finding of invalidity occurs years after the credit was used for compliance. The theory behind this approach seems to be that compliance entities can assess the risk of post-issuance problems and, in the event of liability, can obtain compensation from the entity actually responsible for the discrepancy through contract. This approach also has the advantage of minimizing ARB's administrative burdens, as it need not pursue entities responsible for the invalidation.

However, based on our experience and analysis, this "buyer liability" approach is incompatible with an effective offsets program because it is incompatible with the kind of market (including a secondary market) needed to generate investment in projects. As explained in more detail in the supporting paper, this approach would force each offset credit buyer to assess the risk of a post-issuance discrepancy and effectively "self-insure" for each offset credit. The likelihood of discrepancy is extremely hard to assess, thereby creating an open-ended liability that most risk managers would find unacceptable. In addition, obtaining compensation from the party actually responsible for the invalidation would require potentially long chains of contracts. For these reasons, a buyer liability approach would cause each buyer to apply a steep discount to offset credits — or, even more likely, avoid buying offset credits altogether.

The buyer liability rule is contributing to a lack of comfort with the offsets program among compliance entities and may prevent them from employing this important cost containment tool. As a result the Cap-and-Trade program would lose the benefit of low-cost emission reduction projects, increasing the costs of compliance and, in turn, increasing costs to California consumers.

In sum, for offset projects to work as an effective cost-containment mechanism, the offsets market must work. With a buyer liability approach, the market cannot work.

We understand you may be considering potential modifications to the current buyer liability approach, possibly including approaches involving use of a buffer account. Concerns about the current buyer liability approach have led our diverse group of organizations to work together on an alternative proposal that recommends implementing such a buffer account. Our efforts have been guided by two principles: any alternative must (1) provide absolute assurances of environmental integrity, and (2) avoid imposing undue risks or costs on ARB.

Our alternative proposal, which is explained in greater detail in the attached paper, is roughly modeled on the Forest Buffer Account already established in the Cap and Trade regulations. Our proposal works as follows:

- Before issuing credits to an offset project, ARB would hold back a certain percentage of credits and place the credits in a Compliance Buffer Account (the "CBA").

- In the event that ARB determined that documentation supporting an offset credit is materially not true, accurate or complete, then ARB would immediately retire credits from the CBA to replace those that had been invalidated.

- In the event that the credits were invalidated due to a discrepancy that resulted from willful intent or gross negligence, ARB *would* seek to replenish the credits retired from the CBA from the entity actually responsible for the discrepancy. Requiring the CBA to be replenished in this manner will ensure the long-term viability of the CBA and guard against the moral hazard of lax compliance with the offset program.

- In any event, the credits already issued would remain unaffected, but the program would be made whole by retiring credits from the Compliance Buffer Account.

In the attached paper, we have proposed a holdback percentage that ensures an ample Compliance Buffer Account. However, to address circumstances in which the account runs low, our proposal also establishes a straightforward mechanism to enable the ARB to increase the holdback percentage and thus increase the number of credits in the Compliance Buffer Account.

Under our proposal, the market itself — not ARB — bears the risk of flawed credits. However, rather than requiring each compliance entity or other buyer to manage this risk on a project-by-project basis, the proposal effectively has the entire market taxing itself — by taking issued credits out of the market — in order to create a buffer account that ensures the environmental integrity of the program. In our view, this approach is just as effective in ensuring environmental integrity, but far more efficient and consistent with a robust market. The approach will result in more emissions-reducing offset projects, while also providing an ironclad compliance backstop.

Finally, in our judgment, this proposal does not impose unreasonable administrative burdens on ARB:

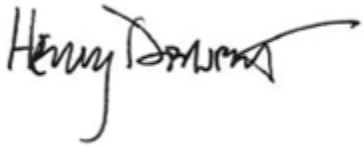
- We are asking ARB to seek credits from the responsible entity to replenish those retired from the CBA only in cases of malfeasance. This will help to avoid the problem of moral hazard, an interest that we share with ARB.

- We have proposed a one-size-fits-all holdback percentage for offset issuance. We also have proposed a particular number for that percentage, and outlined the rationale.

- Management of the Compliance Buffer Account itself involves nothing more than retiring credits in the event of discrepancies, and, if necessary, increasing the holdback percentage to ensure the account remains sufficiently large.

We respectfully request that ARB consider our proposal. Handling the potential invalidation of offsets is a challenging issue. However, establishing a broad, functional offsets policy is vital. We stand ready to answer any questions regarding our proposal and to provide whatever assistance we can as ARB develops its approach to this issue. Toward that end, please feel free to contact Ethan Ravage (ravage@ieta.org), Nico Van Aelstyn (NvanAelstyn@bdlaw.com), or Kyle Danish (KWD@vnf.com).

Sincerely,



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