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COMMENTS ON THE SECOND MODIFIED TEXT OF ARB'S PROPOSED CAP-AND-TRADE REGULATIONS

Submitted by:

Coalition for Emission Reduction Policy (CERP)

Submitted to:

California Air Resources Board

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EXECUTIVE SUMMARY

The Coalition for Emission Reduction Policy (CERP) appreciates that ARB may not make further modifications to its cap-and-trade regulations this year. Accordingly, CERP has divided its comments into: (1) recommendations for clarifications that ARB could offer in the Final Statement of Reasons and (2) recommended modifications to the cap-and-trade regulations for ARB to consider in further rulemakings in 2012.

Final Statement of Reasons: Recommended Clarifications

- *Early Action.* Identify the earliest date an early action project can transition to a Compliance Offset Protocol. (See p. 9 of the attached comments.)

- *Early Action.* Provide further clarity about how the early action system will work in instances in which credit holders submit the project paperwork. (See p. 10 of the attached comments.)

- *Review of Protocols.* Clarify that the review of protocols pursuant to § 95971(b) will not override the critical principles that: (1) revision of a Protocol shall not affect the validity of credits already issued under the original version of that Protocol; and (2) any offset project shall be subject to the version of a Compliance Offset Protocol in effect when its crediting period began for the duration of that crediting period. (See p. 12 of the attached comments.)

- *Biogas.* Clarify that § 95852.1.1(a)(2)(A) – under which biomass-derived fuel contracted after January 1, 2012 may be eligible for the program provided that it is for "an increase in biomass-derived fuel production capacity" – also covers production from a *new facility*. (See p. 14 of the attached comments.)

- *Biogas.* Clarify the interrelationship between § 95852.2(a)(8) and § 95852.1.1, *i.e.,* the fuel specified in § 95852.2(a)(8) is fuel that is otherwise eligible pursuant to 95852.1.1. (See p. 15 of the attached comments.)

- *Biogas.* We appreciate the modifications to § 95852.1.1(b). However, the language in the provision is exceedingly difficult to parse, creating the risk of misunderstandings and disputes. We respectfully recommend that ARB include a "plain language" explanation in the Final Statement of Reasons. (See pp. 15-16 of the attached comments.)

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Recommended Modifications to the Cap-and-Trade Regulations

- *Offset Invalidation.* Move away from "buyer liability" to an alternative approach. (See pp. 5-7 of the attached comments.)

- *Offset Invalidation.* Modify § 95985(c)(2) to add a *materiality* element, i.e., by limiting the scope of the provision to situations in which a project is "not in material accordance" with regulations. (See p. 8 of the attached comments.)

- *Early Action.* If the project originally was verified by a verification body that has earned an ARB accreditation, it should be sufficient for that verification body to attest to the accuracy of its original verification. (See p. 9 of the attached comments.)

- *Forestry Early Action.* When determining the required contribution to the buffer account, ARB should not consider tons voluntarily retired in the Early Action Offset Program. (See p. 13 of the attached comments.)

- *Forestry.* The definition of Forest Owner (§ 95802(109)) should not only exclude governmental third parties that hold a conservation easement, but also private parties that hold such interests. (See p. 13 of the attached comments.)

- *Forestry.* In sections 2.1.1, 2.1.2 and 2.1.3 of the U.S. Forestry Compliance Offset Protocol, either remove the requirement for terminating contracts with other registries or at least modify the phrase "legal and contractual relationships" to state instead "legal and contractual obligations related to the offset credits and protocol in question." (See p. 14 of the attached comments.)

- *Biogas.* Extend the deadline under § 95852.1.1(a)(1)(C) for which gas must flow after a completed CEC application from 10 days to 30 days. (See p. 15 of the attached comments.)

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I. INTRODUCTION

The Coalition for Emission Reduction Policy (CERP) appreciates this opportunity to provide comment on the California Air Resources Board's (ARB) second proposed modifications to the Cap-and-Trade Regulations.[1] These comments incorporate by reference all previous CERP comments, including the August 11, 2011 comments in response to the first proposed modifications to the Cap-and-Trade Regulations.

CERP exists to educate policymakers and the general public about the benefits of using market-based approaches in state and federal policies to address emissions of greenhouse gases (GHGs). CERP brings together leading companies from the energy, financial services, and emissions reduction project development sectors. More information about CERP is available at www.uscerp.org. A list of members is also included in Appendix A of these comments.

CERP firmly supports the goal of ensuring that California creates an environmentally rigorous and highly functional offset system within its cap-and-trade program. The use of offsets will help to contain the costs of achieving the A.B. 32 emission limits while also serving as a bridge to future emission reduction possibilities. California has an important opportunity to serve as a model for other regional and federal greenhouse gas regulatory programs in the United States and the around the world, and the success of its program will be a crucial step forward in advancing the goal of reducing GHGs.

The importance of offsets for cost containment is shown by ARB's own March 24, 2010 economic analysis of the program. As part of this analysis, ARB modeled the program under both a "with offsets" scenario (which assumes utilization of offsets up to the 8% limit) and a "no offsets" scenario. ARB's modeling concluded that, with offsets, an allowance price of $30 in 2020 is sufficient to achieve the reductions needed to meet the cap. In the "no offsets" case, by contrast, it is not possible to achieve the emissions target even with an allowance price of $100 in 2020. Indeed, the analysis concluded that the likely allowance price in 2020 in the "no offsets" case would be $148, *causing the regulations to impose $18 billion more in costs to the California economy in that year alone*. Even this "no offsets" scenario assumes that the program's complementary measures are fully effective; if these measures do not achieve all of their intended reductions, the "no offsets" scenario would have even greater adverse economic impacts.[2]

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[1] California Air Resources Board, Proposed 15-Day Modifications to the Regulation for California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms (Cap-and-Trade Regulation), Subchapter 10 Climate Change, Article 5, Sections 95800 to 96022, Title 17, California Code of Regulations, issued September 12, 2011.

[2] *See* "Updated Economic Analysis of California's Climate Change Plan," Staff Report to the Air Resources Board (March 24, 2010), at 39-40.

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CERP believes that ARB has taken a number of positive steps in the latest round of revisions to its cap-and-trade regulations. Such changes will improve the workability of the program while maintaining a high level of environmental integrity. CERP commends ARB staff for its tireless work to implement the first in the nation cap-and-trade program while under significant time and staff constraints, and for its careful consideration of comments provided in response to earlier versions of the regulations.

Despite ARB staff's significant work, however, some sections of the regulations remain confusing or difficult to implement. Making the changes that CERP suggests below would make a large difference in the functionality of the cap-and-trade program, and would therefore help to ensure its success over time. Given that no further changes will be made to the regulation this year, CERP is requesting in several places that the ARB clarify a particular provision in its Final Statement of Reasons.

One of the biggest issues yet to be addressed by ARB is the introduction of additional offset compliance protocols. While CERP recognizes that the 15-day rulemakings are not the appropriate place to introduce new protocols, CERP urges ARB to move forward with new protocols as quickly as possible in order to offer the market certainty concerning what project types will be included. Offset projects take significant time to implement, and thus there will be significant lag time after new protocols are accepted by ARB before projects can be expected to be introduced into the market.

Many models of the California market over time have noted it will be quite short in offsets in the later compliance periods. The eight percent of a compliance entity's obligation that can come from offset projects can alleviate some of the upward price pressure on the market. However, such market flexibility will not be possible without sufficient offset supply. The current four offset compliance protocols will simply not be able to deliver sufficient offset credits to prevent supply problems in the market. The three additional offset protocols that were mentioned at the ARB board meeting on August 24th– pneumatic controllers, rice cultivation, and fertilizer management, are a helpful start if approved, but none will create a sufficient level of supply. Therefore, CERP requests that ARB move expeditiously toward introducing new offset protocols with the ability to contribute significant supply to the compliance market.

II. COMMENTS ON THE SECOND MODIFIED TEXT OF ARB'S CAP-AND-TRADE REGULATIONS

A. Buyer Liability

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As CERP explained in its extensive August 12th comments in response to the first set of 15-day changes – and in all of its previous comments – an approach to offset invalidation that places liability on holders and users of offset credits will stymie the offsets program, resulting in much higher costs for regulated entities and the Californians that use their products. Buyers of offset credits simply have no way to attain sufficient information to accurately judge the small risk that ARB will later determine it made a mistake in issuing offset credits. The inability to quantify the risk will result in the discounting of offset credits and the loss of the liquidity gains possible from offsets. In short, the "buyer liability" approach to offset credit invalidation remains unworkable if the goal is to create a robust cap-and-trade program.

A study by the UCLA Law School Emmett Center on Climate Change and the Environment reached the same conclusions, finding that the invalidation provisions are a "flaw" in the regulations that "could significantly hinder the role offsets play in promoting market liquidity" for at least the first several years of the program. The study further explains:

> Offset buyers are not likely to have any ability to discern if any given offset had material misstatements and, if they are willing to buy offsets at all, will demand a discount. Offset suppliers are likely to see low prices because of this discount. Because relatively few types of offsets are approved, there are likely not large sources of low-cost offset supply. The implication is that, under current regulations, offsets will be a smaller part of the compliance instrument portfolio than contemplated in CARB's Updated Economic Analysis. This will result in (1) higher allowance prices than would obtain without the invalidation rule; and (2) less flexibility, and therefore less liquidity, in the allowance market given a smaller supply of compliance instruments.[3]

For these reasons, CERP cannot support a framework that includes buyer liability for offset credits. CERP and others have come forward with an alternative recommendation – a Compliance Buffer Account – that would that provide the same or greater environmental integrity *and* impose a smaller administrative burden on ARB than a system in which it must chase down every holder and user of credits from a project.

The UCLA paper *also* endorsed the buffer account idea as a "possible solution to the problem that would maintain the overall integrity of the cap" – and noted that the approach would be similar to a mechanism already in the regulations, the Forest Buffer Account.

[3] Bowman Cutter, *et al.*, "Rules of the Game: Examining Market Manipulation, Gaming and Enforcement in California's Cap-and-Trade Program," UCLA Emmett Center on Climate Change and the Environment (August 2011), at pp. 37-38 (citations omitted).

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We regret that ARB has not accepted this recommendation, but remain ready to work with the staff on the development of any other alternative approaches of interest to the agency.

Given that ARB appears set for now on using an approach to invalidation that includes a form of buyer liability, CERP is very supportive of a number of changes that ARB has made to § 95985 of the cap-and-trade regulations that at least will minimize the adverse impacts of buyer liability on the offset program.

In particular, CERP supports the changes to the regulatory language that allow for a three year statute of limitations for ODS projects if an Offset Project Data Report for a particular credit is re-verified by a different verifier within three years. We also support the provision allowing for a three year statute of limitations for other offset project types—currently livestock, urban forest and forest projects—when they have a subsequent Offset Project Data Report re-verified by a different verifier and issued a Positive or Qualified Positive Offset Verification Statement within three years of issuance. (§ 95985(a)(1)). CERP appreciates these changes because the revised process will maintain a very high level of environmental integrity while also allowing projects the flexibility to undertake a second verification to shorten the statute of limitations period and thus remove the cloud of invalidation uncertainty in a timely manner.

CERP also commends ARB for adding § 95985(d) to the invalidation section of the regulations. This new addition addresses one of the primary administrative hazards of a buyer liability approach: it will keep offset credits that are under investigation from trading in the market. This change is important because it will keep unwitting buyers from transacting in potentially problematic credits before any investigation of a particular Offset Credit Data Report is complete. The provision is very welcome. However, we still remain concerned that a buyer liability regime will lead to scenarios in which even a rumor of ARB activity results in problems in the marketplace and waves of commercial disputes.

CERP is very supportive of the removal of "True, Accurate and Complete" language from the reasons for invalidation under § 95985(b)(1). Previously, ARB could invalidate 100% of the credits from a particular Offset Credit Data Report on the basis of some inadvertent and immaterial omission in project paperwork – even if all of the reductions reported in the Offset Project Data Report were real. Because the language in the prior provision was very vague, it would have been extremely difficult for participants to understand how it could be used to trigger invalidation. This would therefore have prevented robust use of the offsets market. Furthermore, this language was not necessary for environmental integrity because the other provisions in the invalidation section are more than sufficient to ensure the integrity of offset credits. For example, if false or inaccurate paperwork results in a material overstatement of reductions or removals, such a scenario is already addressed by § 95985(b)(1).

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Another helpful change to the regulations is the amendment of the provision on "overstatement" of reductions or removals (§ 95985(c)(1)(A)). ARB has made the reasonable change that if such an overage occurs, ARB shall only invalidate the number of credits that correspond to the overage -- not 100% of the credits in that Data Report, which would include credits that correspond to real reductions. This will maintain environmental integrity because any overage will immediately be compensated. It will also prevent projects from being unfairly penalized for small calculation mistakes. This is important because the threat of losing all of a project's credits as a result of a small mistake would keep many project developers and buyers out of the market all together.

CERP members have developed deep concerns about the breadth of the language included in § 95985(c)(2), under which invalidation can occur if the project activity "was not in accordance with all local, state, or national environmental and health and safety regulations" during the relevant Reporting Period. As a practical matter, project activities may temporarily fall out of compliance with any number of unrelated legal requirements in a manner that has no material effect on the extent to which the project generates real emission reductions or removals. The requirement under (c)(2), therefore, could result in "gotcha" scenarios that undermine the offsets program.

For example, forestry activities are currently contending with uncertainties about Clean Water Act requirements as a result of a recent court decision from the United States Court of Appeals for the Ninth Circuit: Northwest Environmental Defense Center v. Brown. This decision held that all improved logging roads with ditches, channels, and culverts must obtain point source permits under the Clean Water Act. The decision is being appealed to the Supreme Court, and is in conflict with decisions in other circuits. Furthermore, EPA has not yet established any procedures for obtaining the required permits. Accordingly, forestry projects face a situation in which – notwithstanding the validity of their emissions abatement and their compliance with requirement specific to offsets – they will be out of compliance with a national environmental regulation irrespective of anything they do. As a result, they would face the very substantial penalty of losing offset credits, even though they are helpless to change the situation.

For these reasons, we recommend modifying § 95985(c)(2) to add a *materiality* element, i.e., by limiting the scope of the provision to situations in which a project is "not in material accordance" with regulations.

CERP applauds ARB for being clear that the requirement to replace invalid credits only applies to credits that have been retired, as explained in § 95985(g).

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Lastly, CERP commends ARB for extending the deadline for replacement of credits to six months rather than 90 days (§ 95985(h)(2)(A). Because entities will need to go out into the market to replace the credits, it is important that there is sufficient time to undertake such transactions. Six months – which is the period that the regulations provide in the case of underreporting of emissions – is a much more reasonable timeframe for credit replacement, and will minimize the risk that a compliance entity, despite good faith efforts, simply does not have enough time to replace the credits prior to the deadline and thus faces additional penalties.

B. Early Action

CERP is generally supportive of the extensive changes that ARB has made to the early action section of the regulations in § 95990. These changes will improve the program and encourage additional participation in early action, which in turn will be crucial for ensuring a sufficient supply of offset credits in the beginning of the cap-and-trade program. However, there are a few particular areas in which CERP feels that additional modifications to the early action regulations would increase clarity and improve the functioning of the market without sacrificing environmental integrity.

1. Early Action Verification

With regard to Early Action Verification, CERP continues to believe, as explained in prior comments, that the original verification of a project should be sufficient if it was undertaken by a verifier that is certified by ARB. Involvement of a second verifier under such circumstances is unnecessary and costly, especially for small project developers.

Thus, CERP again recommends that ARB change the regulations so that an original verification by an ARB-accredited body is adequate, provided that the body attests to the accuracy of its verification.

2. Material Misstatement Rules

On the topic of material misstatement rules, CERP is supportive of the changes to the material misstatement rules such that a verifier will use "reasonable assurances" to determine when the original positive verification report is correct, as explained in §§ 95990(f)(3)(C) as well as § 95990(f)(6) and § 95990(f)(7). This change will help to lower to cost of entering the early action program without compromising environmental integrity.

3. Transitioning to Compliance Protocols

CERP is also supportive of the changes that ARB made to the deadline for creation of early action credits, as discussed in § 95990(c)(3) of the regulations. The regulations now

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allow for an extra year of early action credits, which will be helpful for increasing the supply of credits in the market. CERP is also supportive of the change in § 95990(k)(1) that removes the requirement that early action projects can transition to compliance offsets no earlier than 2013. The removal of a start date for transitioning give projects additional flexibility to move to a compliance protocol as soon as it is ready.

However, CERP requests that ARB include a timeline when the infrastructure for such transitioning will be available in the Final Statement of Reasons. **Put another way, we would like to know the *earliest date* a project could transition to a Compliance Offset Protocol.** The addition of a timeline will give contracting parties a better ability to plan for the transition to compliance projects in their credit transactions.

In addition, CERP applauds the change to § 95990(k)(3)(C) that give early action projects until September 30, 2015 to undertake verification. This will be especially important for forestry projects that have to recalculate their baseline.

4. Individual Credit Holder Participation

Lastly, CERP is appreciative of ARB's attempts to accommodate scenarios in which a project developer does not want to participate into the early action program and individual credit holders still want to be included. ARB has addressed this issue in the revised regulations by allowing individual credit holders to come into the program in § 95990(d). Involving individual credit holders may provide important flexibility to the program.

However, CERP has identified some complexities with such an approach, especially in regard to forestry, where it appears that logistically and practically it will be very difficult for individual credit holders to enter the program without participation of the Offset Project Operator or an Authorized Project Designee.

Early action forestry is especially challenging because participation will require the project developer to be heavily involved even if the individual holders are bringing in credits. Extensive involvement of the project developer seems unlikely if they were not willing to transition the project themselves. If individuals are going to bring forestry credits in under early action, they will either have to guarantee that the project will transition to a compliance protocol, convince the project developer to list with ARB or get permission from the project developer to become the "Authorized Project Designee," as is required under § 95990(d)(1), (e)(1)(A) and (h)(5)(A). Absent any of these scenarios, the individual holder will not be able to participate in early action for forestry projects.

Other complexities involved in allowing individual credit holders into the program include that individual credit holders will be required to provide significant attestations concerning the project's validity. CERP is grateful that ARB has clarified that individual credit holders only have to engage in such attestations when the project developer does not

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come into the program, but wants to highlight that this requirement still will be complicated in practice because a credit holder will not have access to sufficient information to be able to attest to the validity of the credits without the risk of perjuring itself.

At this time, CERP does not have specific recommendations for addressing such problematic aspects. However, our members want to be sure that the ARB is aware of these complexities and is prepared to provide guidance to companies as they try to navigate the new system.

To this end, CERP suggests that ARB use the Final Statement of Reasons as a vehicle to clarify how the individual credit holder system will function. Some questions to be considered include:

- **Will a number of different credit holders be able to submit paperwork?**
- **What if one verifier for one credit holder finds that it agrees with "reasonable assurances" that the initial verification was correct during the desk review, and another finds that a full verification should be required?**
- **How will ARB deal with discrepancies between paperwork generally?**
- **How will credits move between project developer and individual credit holder?**

C. Offset Process and Verification

1. Small Projects

CERP commends ARB for adding an additional threshold for small projects of 25,000 tons or less. Such small projects are now allowed to undertake verification on a two-year schedule, as specified in § 95977(b). This is an important principle of flexibility to apply not only to this requirement, but also to other parts of the regulations. Many otherwise environmentally-valid small projects will not be able to bear the costs associated with all of the many requirements outlined in the regulations.

2. Deadlines

CERP is also appreciative that ARB added a number of additional clarifications and deadlines with regard to the offset process and verification. The changes to §§ 95980(b), 95980.1(a) and 95981(c) will be important for keeping credits from encountering

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bottlenecks and will keep the supply of credits moving briskly through the verification process.

3. Restrictions on Rotation of Independent Verifiers

CERP appreciates that ARB has added a small degree of flexibility to § 95977.1(b)(R)(1), which now requires each Offset Verification Statement to be independently reviewed within the body by an independent reviewer not involved in services for that offset project. However, this provision remains unreasonably restrictive. For example, if a project utilized one verification body on a project for the full six years otherwise permitted under the conflict of interest requirements, the verification body would have to have available *six different individuals who have not worked on the particular project, yet have sufficient expertise with the project type to provide an independent review.* This provision adds cost and complexity to offset verification without a corresponding increase in environmental protection. There are already numerous checks and balances within the verification procedures, and it is significantly more efficient for a small number of individuals to work with a project over time.

For these reasons, CERP urges ARB to eliminate this independent reviewer requirement altogether.

4. Periodic Review of Offset Protocols

In this second round of 15-day changes, ARB has also added language in § 95971(b), which allows for periodic review of the compliance offset protocols. CERP agrees that continuous review of compliance offset protocols is vital.

However, CERP seeks assurances that the new language in § 95971(b) will not override the critical principles in other parts of the regulation that: (1) revision of a Protocol shall not affect the validity of credits already issued under the original version of that Protocol; and (2) any offset project shall be subject to the version of a Compliance Offset Protocol in effect when its crediting period began for the duration of that crediting period.

To this end, in the absence of language changes, CERP requests that ARB clarify these principles in the Final Statement of Reasons.

D. Compliance Penalty

ARB has modified the regulations such that if a compliance entity is required to fulfill an untimely surrender penalty, one-fourth of the required penalty can be repaid using offset credits. These modifications to § 95857(b)(4) are an important change

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because they add additional cost containment flexibility to the requirements without sacrificing environmental integrity. CERP welcomes this change.

E. Forestry

ARB made a number of changes to the regulations regarding the forestry compliance offset protocol as well as the forestry regulations.

1. Buffer Account

With regard to the buffer account for forestry projects, it appears the buffer is to be composed of the full vintage year of credits, not taking into account credits that were already retired. CERP seeks clarification on whether this was ARB's intent, and if so, why such reductions should not be taken into consideration in some way. The buffer based on full vintage years will increase the number of credits needed.

CERP suggests that in the next rulemaking ARB should alter the regulations such that when determining the percentage of tons that must be added to the buffer account, ARB should subtract tons that have already been retired.

2. Registration of Forest Owners

ARB has introduced regulations that address the requirement that forestry owners register with ARB unless they are certain to be joining the compliance program. CERP understands that ARB must at all times have a continual link to a forestry project for permanence reasons, however notes that it is onerous for the entities involved in a forest project to be required to decide for certain in 2012 whether it is going to transition to a compliance protocol in 2015.

3. Definition of Forest Owner

CERP also wants to bring the definition of "Forest Owner" (§ 95802(109)) to ARB's attention. CERP appreciates that ARB modified the definition of forest owner such that it does not include public parties who own conservation easements, but is unclear why the definition change was limited to public parties. CERP requests that ARB further modify the definition such that it also excludes ***private parties*** who hold conservation easements from liability. It does not make sense for private parties to be required to have liability for forest reversals if their only connection to the forest project is through a conservation easement.

4. U.S. Forestry Protocol

In the revised Compliance Offset Protocol for U.S. Forest Projects, there is language in section 2.1.1, 2.1.2, and 2.1.3 that allows for credits from other registries to come into

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the program but requires terminating legal and contractual relationships with other voluntary programs in order to participate. The language states: "If the offset project was an offset project in a voluntary offset program, the offset project can demonstrate it has met all legal and contractual requirements to allow it to terminate its project relationship with the voluntary offset program and be listed using this compliance offset protocol."

CERP appreciates ARB's attempt to increase the flexibility of the program by allowing other registry credits to be included as part of the compliance offset program. However, the provisions in sections 2.1.1, 2.1.2, and 2.1.3 of the forestry protocol are confusing and could inadvertently create problems for a wide swath of early action credits. It appears to require 100% of credits in a particular registry to transition, eliminating the possibly of selective transitioning according to need.

In addition, the Forestry protocol regulations do not currently contain sufficient process to actually allow credits from other programs to be included in the compliance program. Therefore, CERP urges ARB remove such provisions from section 2.1.1, 2.1.2, and 2.1.3 of the Forestry protocol at this time, and add a process for credits from additional registries to be included in the compliance protocol as part of the next rulemaking, which is to take place next year.

If ARB wishes to retain such language in the forestry protocol, it should at least modify the phrase "legal and contractual relationships" to state instead "legal and contractual obligations related to the offset credits in question" or make clear that such provisions do not apply to early action projects.

F. Biogas

1. Contracting Date

CERP appreciates ARB's modifications to § 95852.1.1(a)(2), which clarify the circumstances under which biogas may have a purchasing contract dated on or after January 1, 2012. Allowing the conversion to beneficial use through the recovery of fuel will be a helpful incentive for facilities to create useful energy transfer from biogas, as noted in § 95852.1.1(a)(2)(B).

CERP supports ARB's approach of allowing a later contracting date where there is "an increase in the biomass derived fuel production, at a particular site." (§ 95852.1.1(a)(2)(A)). This provision makes sense because an overall increase in fuel production from a particular site is distinguishable from a "resource shuffling"-type scenario.

However, § 95852.1.1(a)(2)(A) has some ambiguity because it measures the "increase" in terms of "any amount over the average production at that site over the last

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three years." It is not clear whether this language applies in the case of a *newly-constructed facility.* One valid interpretation of this phrase is that production from a new facility would qualify as an increase because there would have been *zero* "average production" from the "particular site" in the previous three years.

It would be very helpful if ARB, in the Final Statement of Reasons, clarified that this interpretation of § 95852.1.1(a)(2)(A) is valid.

Alternatively CERP recommends that ARB clarify the regulations in the next rulemaking by modifying § 95852.1.1(a)(2)(A) to state "an increase in the biomass derived fuel production capacity, at a particular site *or a new production facility. . .* "

In addition, CERP has noticed a contradiction between § 95852.2(a)(8), which states that biomethane and biogas from all animal, plant and other organic matter, as well as landfill gas and wastewater treatment plants, do not count toward an entity's compliance obligation, and § 95852.1.1, which requires that the biogas fuel have a contract for purchasing prior to January 1, 2012.

Therefore, CERP recommends that in the next rulemaking ARB modify § 95852.2(a)(8) to state: "Biomethane and biogas *that is eligible under § 95852.1.1, as applicable,* and from the following sources." This will clarify that in order to be eligible for the compliance exemption biogas must adhere to applicable regulations.

CERP further supports the modifications to § 95852.1.1(a)(1)(C) that allow for flexibility in the contracting date by counting the date that an entity submits an application to CEC as meeting the requirements for January 1, 2012 contracting date.

However, the requirement that gas start to flow 10 days after the completed CEC application may not reasonable for some purchasers depending on the contractual structure in place, and CERP requests that the period be extended to 30 days.

2. Clarification of Offset Credit Creation

CERP also commends ARB for its efforts to clarify § 95852.1.1(b) to make it clearer that offset credits can be generated from projects without removing their compliance exemption.

However, the provision is still very difficult to parse. It would be helpful if ARB offered an explanation of the provision in the Final Statement of Reasons. CERP's understanding is that this section provides for the following:

- **Credits and allowances *are not* available for CO_2 emissions associated**

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with combustion of biomethane, biogas, or other biomass-derived fuel (or the reduction in CO_2 emissions associated with use of fuel for energy instead of the flaring of that biomethane or biogas); provided that

- **Credits *may be* available for avoided methane emissions associated with biomethane or biogas produced from digesters or landfills pursuant to the relevant offset protocols. Such credits may not exceed 23.75 metric tons of CO_2e per ton of captured (or avoided) methane.**

- **Nothing in § 95852.1.1 prevents the generation of Renewable Energy Credits associated with biomass-derived fuels**

III. CONCLUSION

We appreciate your consideration of our comments. Please let us know if you would like to discuss these concepts, or would like further explanation of any of these points or suggestions. We look forward to continuing to work with you to ensure that the California offsets program is effective, efficient, and environmentally rigorous.

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Attachment: CERP Comments to the Air Resources Board on the First Modified Cap-and-Trade Regulations (August 11, 2011)

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Appendix A

Members of the Coalition for Emission Reduction Policy (CERP)

American Electric Power
C-Trade
Dominion
The Eco Products Fund
PG& E
JP Morgan
Camco
Deutsche Bank
Duke Energy
Element Markets
Verdeo

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COMMENTS ON THE MODIFIED TEXT OF ARB'S PROPOSED CAP-AND-TRADE REGULATIONS

Submitted by:

Coalition for Emission Reduction Policy (CERP)

Submitted to:

California Air Resources Board

August 11, 2011

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I. EXECUTIVE SUMMARY

The Coalition for Emission Reduction Policy (CERP) appreciates this opportunity to provide comment on the Air Resources Board's (ARB) proposed modifications to the Cap-and-Trade Regulations and the Mandatory Reporting Regulation (MRR).[1] CERP exists to educate policymakers and the general public about the benefits of using market-based approaches in state and federal policies to address emissions of greenhouse gases (GHGs). CERP brings together leading companies from the energy, financial services, and emissions reduction project development sectors. More information about CERP is available at www.uscerp.org. A list of members is also included in Appendix A of these comments.

CERP supports the goal of ensuring that California creates an environmentally rigorous and highly functional offset system in order to contain the costs of achieving the A.B. 32 emission limits and to serve as a model for other regional and federal greenhouse gas regulatory programs.

The inclusion of an offsets program within the larger set of policy measures designed to meet the A.B. 32 emission limits will offer multiple benefits. The offsets program will broaden participation in the effort to provide climate solutions—including from farmers, forest owners, and others. The program will also encourage innovation in a number of areas, including methane digesters and forest carbon management.

In addition, by expanding the universe of projects and people who can contribute to emission reductions, the offsets program will lower the cost of meeting the overall A.B. 32 emission limits for Californians. Offsets serve as a bridge to the low-carbon economy of the future. Many of the "breakthrough" technologies needed to significantly reduce GHG emissions from capped sectors have yet to be developed or deployed. A cap-and-trade program with a gradually declining cap creates an incentive to develop these technologies. While those technologies are being brought to market, offset projects can provide the verifiable and actual emission reductions needed to meet current compliance requirements. A significant component of the cost containment provided by offsets is their ability to give regulated entities flexibility in the timing of internal emission reductions.

Some stakeholders have made the argument that the proposed A.B. 32 regulations allow too generous a limit for the use of offsets—and that it will be possible for covered entities to use offsets to avoid making any reductions at all. This claim is a gross distortion. It ignores the fact that the vast majority of reductions under the A.B. 32 regulations will

[1]California Air Resources Board, Proposed 15-Day Modifications to the Regulation for California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms (Cap-and-Trade Regulation), Subchapter 10 Climate Change, Article 5, Sections 95800 to 96022, Title 17, California Code of Regulations, issued July 25, 2011 and Proposed 15-Day Modifications to the Regulation for the Mandatory Reporting of Greenhouse Gas Emissions (Mandatory Reporting Regulation), Subchapter 10 Climate Change Article 2, Sections 95100 to 95133, Title 17, California Code of Regulations, issued July 25, 2011.

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result—and are already resulting—from measures other than the cap-and-trade program, including the renewable electricity and energy efficiency standards. The Air Resources Board's (ARB) own data show that four out of every five tons of reductions will come from these complementary measures.[2] Accordingly, the cap-and-trade program only will account for a small fraction of the overall reductions needed to comply with A.B. 32—*and offsets, even with full utilization up to the 8% limit, will account for an even smaller share*.

Yet, full utilization of offsets is critical to achieving the A.B. 32 emission limits at a reasonable cost. The importance of offsets for cost containment is shown by ARB's own March 24, 2010 economic analysis of the program. As part of this analysis, ARB modeled the program under both a "with offsets" scenario (which assumes utilization of offsets up to the 8% limit) and a "no offsets" scenario.[3] ARB's modeling concluded that, with offsets, an allowance price of $30 in 2020 is sufficient to achieve the reductions needed to meet the cap. In the "no offsets" case, by contrast, it is not possible to achieve the emissions target even with an allowance price of $100 in 2020.[4] Indeed, the analysis concluded that the likely allowance price in 2020 in the "no offsets" case would be $148,[5] *causing the regulations to impose $18 billion more in costs to the California economy in that year alone*.[6] Even this "no-offsets" scenario assumes that the program's complementary measures are fully effective; if these measures do not achieve all of their intended reductions, the "no offsets" scenario would have even greater adverse economic impacts.

The reason for the cost difference between the "with offsets" and "no offsets" scenarios is that the latter would require all reductions needed to meet the A.B. 32 emission limits to occur at the facilities owned by covered entities. However, there are only a certain amount of cost-effective reductions available at such facilities in the near-term; after such reductions are made, the cost of additional reductions increases substantially. And these costs will be passed through to consumers. As ARB's own analysis explains:

> The no-offsets case examines a cap-and-trade program design that does not allow lower-cost offset credits to substitute for the most expensive emission-reduction options otherwise available. Because the price of allowances reflects the cost of the most expensive emissions reductions needed to meet the cap, not allowing offsets has a large effect on allowance prices. The results of this case show that offsets can help contain costs within the cap-

[2] Air Resources Board, Supplement to the AB 32 Scoping Plan Functional Equivalent Document, at p. 9, Table 1.2-1 (showing that 146.7 mmtCO_2e of reductions are needed to meet the A.B. 32 emissions limit, of which all but 34.4 mmtCO_2e are expected to result from measures other than a cap-and-trade program.)
[3] "Updated Economic Analysis of California's Climate Change Plan," Staff Report to the Air Resources Board (March 24, 2010).
[4] *Id.*, at p. 39.
[5] *Id.*, at p. 40 (Table 16).
[6] *Id.*, at p. ES-7 (Table ES-2).

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and-trade program and prevent higher energy prices for California's businesses and residents, allowing continued economic growth.[7]

Accordingly, we all have much at stake in the development of the rules for the offsets program. To be clear, our highest priority is ensuring that these rules set high standards for environmental rigor, allowing only high quality projects to earn credits. However, it is also important to recognize that the offsets program is not a "natural" market; it is a market that is entirely resulting from and formed by the cap-and-trade regulations. Accordingly, ARB's regulations can either create a functional or a dysfunctional market.

Costs are not the only issue. In the area of offsets, as in so many other policy initiatives related to climate change, California is breaking ground for the rest of the United States. The state is creating the largest greenhouse gas cap-and-trade program in North America. The experience of this program will set a course for other states and the country in general. California also has a chance to learn from the mistakes of and improve upon the experience of the Clean Development Mechanism. For these reasons, ARB's rules for offsets will not only affect the regulatory costs borne by California—the rules also will set an important precedent for future North American and international programs. If the final regulations result in an unviable offsets program, it will be a set-back for climate policy design generally.

We appreciate that ARB already has been responsive to many recommendations for improving the offset regulations. However, the regulations still contain a number of measures—the "buyer liability" system, in particular—that impose costs and complexity without furthering environmental rigor. As a result, we currently are far closer to the "no-offsets" case than we are to the "with-offsets" case—even if greater supply becomes available with the addition of new offset project types and protocols.

The Coalition thanks the ARB staff for the considerable work that went into these proposed revised regulations, and for their careful consideration of comments provided earlier. CERP is particularly appreciative of the following changes:

- Making clear that early action credits are available for projects based on the four approved protocol types.
- The introduction of an expedited verification process for early action credits.
- More reasonable conflict-of-interest requirements for early action projects.
- A clarified pathway for transitioning early action projects to the compliance program.

[7] *Id.*, at ES-6.

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- Clarifying that the rotation of verifiers is based on the individual project, not the project operator.
- Establishing a workable approach to addressing intentional forestry reversals.
- Modifying the reporting period approach to make it more viable.
- Reducing the record retention period to 15 years.
- Extending the duration of an offset project registry approval to 10 years.
- Allowing forest projects on-site visits once every six years.
- Including a allowance compliance exemption for emissions from use of biogas from digesters.
- Extending the contracting deadline for purchase of biomass-derived fuel.

The comments below provide detailed suggestions on ways in which the proposed regulations could be modified to create a more effective offsets program and to ensure a reliable supply of cost-effective, high-quality offsets. Of primary importance is the need for ARB to move away from the "buyer liability" system for addressing post-issuance offset problems. Unless changes are made to that approach, we are concerned that the offsets program will very nearly amount to the "no offsets" scenario described in ARB's economic analysis.

In addition to a shift away from "buyer liability," we recommend the following modifications:

- Apply the forest buffer account approach to dealing with invalidation for all offsets.
- Limit the statute of limitations for offset credit invalidation to the earlier of five years or the finalization of a second verification.
- Remove liability for offset project data reports that are not "true, accurate, or complete" because it is unreasonable and addressed by other liability conditions in any event.
- Limit liability from "overstatement" to the extent of the overstatement.
- Allow responsible entities six months to replace compliance instruments that are invalidated.
- Expand the number of protocols eligible for early action credits.
- Allow the original verifier to conduct a desk review of early action credits if ARB-accredited.
- Change the early action "offset material misstatement" threshold from three percent to four percent.

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- Add a *de minimis* tonnage threshold for "offset material misstatement" for early action projects.
- Clarify the consequences of "offset material misstatement" for early action projects.
- Streamline the listing process for early action projects.
- Clarify that only holders of credits that seek early action credits must register.
- Alter the early action regulations to remove inadvertent free rider problems.
- Apply the quantitative usage limit of eight percent over all years of the program.
- Allow an increase in the usage limit if the allowance price containment reserve is depleted.
- Allow reasonable extensions of the reporting deadline.
- Add a deadline for ARB to determine if an offset report is complete.
- Extend the crediting deadlines for projects that are required to re-submit to a new offset project registry because of registry disapproval.
- Simplify the language that codifies the "once in-always in concept" for biomass derived fuel that is purchased before January 1, 2012.
- Remove the requirement that a biogas contract must remain in effect with the same California operator.
- Expand the definition of "increased capacity" in the biogas regulations to include an efficiency increase and conversion to a flare.
- Remove the apparent prohibition on the use of offset credits from biogas projects.
- Remove the requirement in the livestock offset protocol that every destruction device have a meter installed.
- Remove the requirement in the Mandatory Reporting Regulation (MRR) section 95131(i) for additional verifications of biomass-derived fuels in the event of changes to suppliers or volumes.
- Make the requirements for wood and waste biomass consistent with the California Energy Commission's requirements.
- Apply a simplified monitoring regime for forestry projects after the end of their crediting period.
- Clarify whether avoided conversion projects may transfer the land to public ownership as an alternative to a conservation easement.
- Apply the requirement to replace issued credits after termination only to credits issued in the proceeding crediting period.

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- Alter the baseline projection estimation requirement for forestry projects such that it is for the crediting period, not 100 years.
- Clarify that compensation for intentional reversals should apply only to reversals of stocks for which credits have been issued.
- Clarify that contributions to the forest buffer account should be required only during the crediting period.
- Remove discontinuities between the main verification regulations and the protocols with respect to verification requirements by keeping project-specific requirements in the protocols.
- Remove unnecessarily prescriptive verification requirements.
- Allow covered entities to use offset credits to pay the compliance penalty.

II. COMMENTS ON THE PROPOSED REVISED REGULATIONS

A. Early Action

Offset supply will be of particular importance during the first years of the cap-and-trade program because covered entities will need immediately available emission reductions and some offset projects will remain in the development phase. CERP is therefore very supportive of ARB's decision to allow early action credits based on the four approved protocol types. In the revisions to the cap-and-trade regulations, important steps have been taken to streamline the early action provisions—including the introduction of an expedited verification process and more reasonable conflict-of-interest requirements. However, additional changes can be made to enhance the program and improve its effectiveness.

1. *Expand the Protocols Eligible for Early Action Credits.*

CERP encourages ARB to expand early action eligibility beyond the four currently approved Climate Action Reserve (CAR) protocols to substantially similar voluntary protocols from other well-established project registries. CERP also supports the addition of section 95990(c)(5)(E) of the regulations, which reserves a provision "for additional early action offset project protocols."

CERP is pleased that ARB is considering the addition of new early action protocols because they would increase the available supply of early action offset credits. The additional influx of early action credits will help to ease the strain of program compliance in the early years of its development. CERP renews its recommendation that ARB make landfill projects eligible for early action credits because such projects have a well-

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developed track record and will be easy to include in the existing ARB early action program.

2. ***Allow Original Verifier to Conduct Desk Review if ARB-accredited.***

With regard to the regulations for Early Action Verification in § 95990(f), CERP is supportive of ARB revisions that allow a "desk review" of projects for re-verification in § 95990(f)(3). The desk review approach will reduce the costs of re-verification, which otherwise may prove prohibitive for small projects. CERP further supports ARB's decision to allow the same verifier to do a desk review for all vintage years for which early action is claimed, and for all the relevant years to be verified at once.

CERP urges ARB to consider an additional streamlining step. Specifically, if the original CAR verifier for an early action project earns an accreditation from ARB, it should be possible for this verifier to perform the desk review. It is unclear to CERP why this approach would raise any concerns of "bias." Precluding such an approach will result in additional costs without increasing environmental integrity.

Accordingly, we recommend the following modification to § 95990(f):

> (1) The project must be verified by an ARB-accredited verification body that meets the accreditation requirements in section 95978. The verification body performing regulatory verification pursuant to this section must be different than the verification body that conducted offset verification services for the early action offset project under the Early Action Offset Program <u>unless the verification body that conducted offset verification services under the Early Action Program is an ARB-accredited verification body that meets the accreditation requirements in section 95978.</u>

3. Change the "Offset Material Misstatement" Threshold from Three Percent to Four Percent.

Under § 95990(f)(4), a finding of "offset material misstatement" for a particular Offset Project Data Report year triggers a full re-verification of the project. Section 95590(f)(4) defines offset material misstatement as a misstatement of the smaller of: (1) three percent or more; or (2) 25,000 metric tons CO_2e. In CERP's view, the three percent threshold may trigger an unnecessarily large number of costly re-verifications, and therefore we suggest changing the percentage threshold in § 95990(f)(4) to four percent. This is a reasonable compromise between three percent and the five percent level at which projects may not receive Climate Reserve Tonnes in the first instance. Accordingly, this compromise level is consistent with the dual goals of upholding environmental integrity and minimizing the number of unnecessary and expensive re-verifications.

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4. Add a De Minimis Tons Threshold for "Offset Material Misstatement."

As discussed above, full re-verification would cause many small early action projects to be uneconomical. Accordingly, CERP respectfully requests that ARB add a *de minimis* tons-based threshold for re-verification below which a finding of offset material misstatement would not trigger a full re-verification. CERP suggests 10,000 metric tons for the material misstatement threshold because it mirrors the level that triggers reporting under the Mandatory Reporting Rule.

5. Clarify Consequences of "Offset Material Misstatement."

Section 95990(f)(4) provides that in the event of a finding of offset material misstatement with respect to a particular Offset Project Data Report year, the verification body must conduct full verification services for the project "for all years eligible and applicable pursuant to section 95990(c)(1)." It is unclear from this language whether ARB intends full re-verification to apply: (1) only to the year(s) for which there was a material misstatement or (2) for *all* years for which the project seeks early action credits. ARB officials have told CERP members that they intend the former. To avoid confusion, we recommend making the following edits to §95990(f)(4) (which includes the modification suggested in sections A.3 and A.4 above):

> If during the desk review the verification body concludes that the offset project documentation for an Offset Project Data Report year includes an offset material misstatement of ~~three~~ four percent or more or the offset material misstatement equates to greater than 25,000 metric tons CO_2e, whichever is smaller, then the verification body must conduct all offset verification services in section 95977.1 and any additional verification requirements in the protocols identified in section 95990(c)(5) for an early action offset project of that type, for the year to which the Offset Project Date Report applies ~~all years eligible and applicable pursuant to section 95990(c)(1)~~; provided that an offset material misstatement that equates to 10,000 metric tons CO_2e metric or less shall not result in the offset verification service requirements of this section. Offset verification services for each Offset Project Data Report year may be done by the same verification body that performed the desk review and may be applied as one single offset verification service and meet the following requirements.

6. Streamline the Listing Process for Early Action Projects.

CERP respectfully requests that ARB streamline the listing process of an early action project. Section 95990(e) suggests that offset project operators for early action projects will have to go through the entire listing and information submission process that would

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apply for a "compliance" offsets project. CERP believes that this adds needless costs, especially given that the Climate Action Reserve and other registries already require much of the same information and require that such information be made public. A shorter listing process—such as a form on which the Offset Project Operator or Designee could provide basic information about the project and the vintages and volumes to be transferred—could provide sufficient information for early action projects while maintaining environmental integrity. It also would help speed implementation by ARB.

7. Clarify that Only Holders of Credits That Seek Early Action Must Register.

Section 95990(j)(1) and (2) of the proposed revised regulations appear to require that *all* holders of early action credits from a particular project must register in order for ARB to issue ARB Early Action Credits for the project. This language is problematic because some holders of credits from a project listed under a non-ARB offset project registry have no intention of exchanging early action credits for ARB Early Action Credits—and yet, these entities would be required to register and prove ownership of such credits in order for *any* holders to receive ARB Early Action Credits. ARB staff have told CERP members that their intention is that only those holders that wish to transition their credits should have to register. In order to avoid confusion, we recommend the following modifications to § 95990(j):

> (j) Registration and Transfer of ARB Offset Credits for Purposes of Early Action. An ARB offset credit issued pursuant to section 95990(i) will be registered by creating a unique ARB serial number. ARB will transfer the serial numbers into the Holding Account of ~~the~~ a holder~~s~~ of the original early action offset credit within 15 working days of the notice of issuance pursuant to section 95990(i)(4), unless otherwise required in section 95990(i)(1)(D), and as long as the holder~~s~~ meet~~s~~ the following requirements
>
> > (1) ~~All~~ The holder~~s~~ of the original early action offset credit~~s~~ register~~s~~ with ARB pursuant to section 95830; and
> >
> > (2) ~~All~~ The holder~~s~~ of the original early action offset credit~~s~~ proves ownership of ~~those~~ the offset credit~~s~~, including original serial number~~s~~ issued by the Early Action Offset Program.

8. CERP Supports the Revised Approach on Conflict-of-Interest Requirements.

CERP supports the changes to the conflict-of-interest requirements for early action credits in § 95990(g). The December 2010 version of the regulations required that the new verifier be free of conflicts of interest with the project operator and *any and all* of the

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holders of credits from the project. CERP recommended limiting the conflict-of-interest test to the project operator and any holder of a large number of the credits. ARB was responsive on this point, limiting the "conflict-of-interest" test to the holder of 30 percent or more of the credits. CERP believe that the changes now provide a reasonable conflict-of-interest structure for early action.

9. CERP Supports the Clarified Pathway for Transitioning Projects to the Compliance Program.

CERP also appreciates that ARB was responsive to the group's request to provide a clear pathway for transitioning early action projects into the "compliance" ARB program, as detailed in § 95990(k). CERP supports the change in the deadline for transitioning to compliance protocols. February 28, 2015 is a reasonable deadline for transitioning and will be very helpful in avoiding bottlenecks caused by many projects attempting to transition over a short amount of time.

However, CERP seeks clarification about the timeframe for transitioning. The ambiguity arises because the Climate Action Reserve protocols listed in § 95990(c)(5) do not specify a timeframe for the annual verification. Accordingly, we request clarification that an Early Action Offset Project has "nine months after the conclusion of each Reporting Period" to verify its 2014 offset credits, which is consistent with the time period for verification in § 95977(d). If this is correct, an Early Action Offset Project "must be *listed* with ARB or an Offset Project Registry by February 28, 2105" (§ 95990(k)(3)(C)), but has until September 30, 2015 to *complete the verification* of its 2014 offset credits. This additional time will especially important for forestry 2.1 projects that are required to recalculate their baselines prior to transitioning.

10. The Early Action Regulations May Create Inadvertent Free Rider Problems.

CERP is concerned that the early action regulations may create an inadvertent "free rider" problem that could complicate and discourage the crediting of early action projects.

In many cases, a single project will have many holders of credits. In those cases, the credit holders and offset project operator will have to negotiate an apportionment of the costs of going through the early action process. Two elements of the revised regulations may complicate this process: (1) the apparent requirement in § 95990(f) that any verification report be made public; and (2) the requirement in § 95990(j) that any holder of original early action credits be issued Early Action Credits (provided that it does nothing more than register and prove its ownership of the underlying credit). As a result of these elements, any holder of an early action credit will have the ability to "hold out" in negotiations on the apportionment of verification costs—because the holder will know that

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as soon as the verification report is completed, it has a right to the resulting Early Action Credit irrespective of whether it contributed to paying the cost of implementing the verification.

CERP is considering potential modifications that could avoid this free rider problem, and looks forward to communicating with ARB on this issue very soon.

B. Quantitative Usage Limit

1. Apply the Eight Percent Limit to All Years of the Program.

CERP appreciates that ARB modified the quantitative usage limit in § 95854 of the revised regulations to allow the eight percent quantitative limit to apply to the biannual compliance period of 2013-2014 and the subsequent triennial compliance periods, rather than to each annual compliance obligation.

However, CERP continues to believe that the eight percent quantitative limit on offsets will significantly raise the cost of compliance and is unnecessarily restrictive. Because it appears likely that there will not be sufficient offset supply in the early compliance periods to meet demand, covered entities will not be able to purchase the maximum number of offsets and could lose the cost containment benefits that offsets provide.

As an alternative, CERP supports the proposal to modify the regulations to apply the eight percent limit to provide that covered entities are able to use unused offsets in future compliance periods as long as their *total* offset usage never exceeds eight percent of their compliance obligation. This would entail changing the regulations to allow the eight percent usage limit to apply over the entire term of the program to date. This could provide important cost relief if offset supply is low in early years of the program and compliance entities are therefore only able to employ a small number of offsets during those periods.

2. Authorize an Increase in the Usage Limit if the Allowance Price Containment Reserve is Depleted.

CERP further recommends that ARB include a provision in the final regulations that would allow the quantitative offset limit to be modified in the future if allowance prices become too high. As CERP suggested in December 2010, the regulations should provide that if at any time half the allowances from the Allowance Price Containment Reserve have been purchased, additional cost containment should be provided by increasing the offset usage limit for that compliance period. If depletion of the Reserve occurs, ARB should also consider using revenue from the sale of Reserve allowances to purchase offsets which can then be used to replenish the Reserve. This system would allow for important price

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containment that would prevent the program from faltering under difficult economic conditions.

C. Biogas

Biogas projects such as methane digesters will be an important source of offset credits in the California cap-and-trade program. In addition, pipeline quality biomethane will also provide a crucial carbon-neutral source of energy for many entities that make use of it for electricity generation, heat, and transportation fuel. Most biogas and biomethane projects operate on very thin profit margins, and thus it is critically important that this area of the cap-and-trade regulations is simple and efficient while maintaining a high degree of environmental integrity.

1. CERP Supports the Compliance Exemption for Biogas from Digesters.

CERP is supportive of ARB's modifications to § 95852.2(a)(8), which now provides a compliance exemption for emissions from biomethane and biogas from digesters. The emissions generated by combusting materials in methane digesters are carbon neutral and therefore digesters should qualify for the same compliance exemption granted to other biogenic sources. In exempting digester biogas from a compliance obligation, ARB is encouraging methane digesters to invest in electricity generation equipment rather than simply flaring the methane produced; the former will result in greater overall reductions in emissions.

2. CERP Supports the Extension of the Contracting Deadline for Purchase of Biomass-Derived Fuel.

ARB has also made helpful clarifying changes to § 95852.1.1 that will further encourage the use of biomass-derived fuels in California. In particular, in § 95852.1.1(a)(1), the required contracting date for the purchase of biomass-derived fuel within California has been extended to January 1, 2012. CERP is very supportive of this extension of time, as the extension will allow entities currently in the middle of the contracting and regulatory approval process to complete that process and successfully participate in the program.

CERP further supports ARB's decisions: (1) not to restrict the compliance exemption for "long term" contracts, and (2) to allow any contract that meets the January 1, 2012 contract date to be eligible as a biomass derived fuel.

3. Simplify the language that codifies the "once in-always in" concept for biomass derived fuel that is purchased before January 1, 2012.

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CERP appreciates that ARB intends for a biomass derived fuel that is eligible for the compliance exemption under § 95852.1.1 to remain eligible for the compliance exemption in future years of the program. However, we urge ARB to clarify the language that attempts to codify this concept. In particular, §95852.1.1, Section a, subpart #1 states:

> The contract for purchasing any biomass derived fuel must be in effect prior to January 1, 2012 and remain in effect or have been renegotiated with the same California operator within one year of contract expiration.

The phrase starting with "and remain in effect or have been renegotiated…" is not necessary for the codification of this concept because § 95852.1.1 already contains a requirement that the verifier be able to demonstrate that the fuel was eligible under a contract that was in effect prior to January 1, 2012. In particular, § 95852.1.1, Section a, subpart #3 states:

> The fuel being provided under a contract dated after January 1, 2012 is for a fuel that was previously eligible under sections 95852.1.1(a)(1) or (2), and the *verifier is able to track the fuel to the previously eligible contract* (emphasis added);

In addition, further language in §95852.1.1, Section a, subpart #1 requires that physical transfer of the fuel begin within 90 days after a signed contract; or, if physical transfer of the fuel begins after 90 days, then the first date of physical fuel transfer is considered the contract signing date.

In other words, the language in the other sections already provides that if a contract is in effect by January 1, 2012, the biomass derived fuel will be considered eligible—and, if the contract is renegotiated, the verifier must be able to trace the quantity of eligible biomass-derived fuel back to the original contract in order for the compliance exemption to be retained.

Removing the renegotiation requirement does not impinge on the environmental rigor that California is striving to achieve, since the subsequent language requires that physical fuel be transferred within 90 days and that the verifier be able to trace back to the previously eligible contract. At the same time, it ensures that fuel providers have the flexibility to renegotiate their contract without being subject to a one year time limit; such a limit could be unrealistic in many cases given the levels of regulatory approvals that must be obtained in California. Contract renegotiations and approvals can be lengthy processes in California, and could take longer than one year, especially if they are contingent on approvals by regulatory bodies such as the California Public Utilities Commission (CPUC). Given this reality, requiring the contract to be "renegotiated within one year of contract expiration" places a significant burden on the fuel provider when the timeline of events may be beyond its control. Therefore, CERP urges ARB to remove the phrase "and remain

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in effect or have been renegotiated with the same California operator within one year of contract expiration".

In addition, CERP urges ARB to modify §95852.1.1, Section a, subpart #4 to further clarify the "once in, always in" concept. This section states:

> Once a certification program is in place, a fuel which meets the requirements of sections 95852.1.1(a)(1) and 95852.1.1(a)(2) will always be considered to have met the requirements in section 95852.1.

The phrase "once a certification program is in place" does not seem necessary, since ARB requires annual verification of the biomass derived fuels prior to the implementation of a certification program. Moreover, it is not clear when a certification program will come into fruition, and this phrase could be read in such a way that a biomass-derived fuel is not "always considered to have met the requirements in section 95852.1" until the certification program is in place. We believe ARB's intent is for any biomass-derived fuel that is adequately verified to continue to remain eligible for the compliance exemption, and because ARB has put rigorous verification requirements in place to do so—and will further be developing a certification program for biomass-derived fuels—this phrase is unnecessary and could lead to groundless ineligibility of fuels. CERP urges ARB to delete this phrase.

4. Remove the Requirement that a Contract Must Remain in Effect with the Same California Operator.

If ARB determines that the phrase "and remain in effect or have been renegotiated with the same California operator within one year of contract expiration" must remain in the language, CERP urges ARB to remove the requirement for the contract to be in effect "with the same California operator." This requirement is needlessly cumbersome. CERP sees no reason why contracting with a different California operator after the original contract expiration should bar entities from involvement with the program. Further, this requirement will allow operators with existing contracts to have unfair monopoly purchasing power within California with regard to specific producers. Accordingly, we recommend deleting "*with the same California operator*" and substituting "*with a California operator*."

5. Expand the Definition of "Increased Capacity" to Include an Efficiency Increase and Conversion to a Flare.

CERP is supportive of ARB's added language in § 95852.1.1(a)(2), which clarifies that an increase in fuel production includes "any amount over the average of the last three calendar years of production." However, CERP respectfully requests that ARB add efficiency increases and the conversion of biogas to beneficial uses to the definition of

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increased capacity. If a methane capture facility installs a higher efficiency generator and thereby produces more carbon neutral electricity, overall emissions will be reduced. In addition, if a facility invests in converting a flare to a generator, overall emissions similarly decline. Therefore, both these instances should meet the "increased capacity" standard and fall under the compliance exemption. Accordingly, we recommend modifying § 95852.1.1(a)(2) as follows:

> (2) The fuel being provided under a contract dated after January 1, 2012 must only be for an amount of fuel that is associated with an increase in the biomass-derived fuel producer's capacity, new production or recovery of the fuel that was previously destroyed without producing useful energy transfer. Increased capacity is considered any amount over the average of the last three calendar years production, an increase in the efficiency of the facility, or the conversion of a flare to a generator.

6. Remove the Apparent Prohibition on Use of Offset Credits from Biogas Projects.

CERP appreciates and supports the language in § 95852.1.1(b) of the revised regulations that makes clear that generation of renewable energy credits (RECs) will not prevent a biomass-derived fuel from benefiting from the compliance obligation exemption.

However, the rest of § 95852.1.1(b) is confusing, overbroad and unnecessary—and we urge ARB to delete it. The provision is overbroad in that it effects a sweeping restriction on offset credits and allowances. It is confusing in that it is unclear whether the restriction only applies to *ARB-issued* credits and allowances, or also to credits and allowances from other programs—and, if it is the latter, it is unclear what authority ARB has to prohibit such uses. Additionally, the category of emissions and activities to which it applies is also vague and overbroad: "fuel production that would otherwise result in holding a compliance obligation for combustion CO_2." It is unclear to us what this means.

In any event, this restriction is unnecessary to the extent that it applies to ARB offset credits because the regulations already clearly specify *exclusive* pathways for the creation of ARB offset credits: through the protocols.

In particular, it is our understanding from discussions with ARB officials that the Livestock Protocol allows for offsets credits for avoided methane emissions, but *not* for emissions of biogenic CO_2 resulting from the use of biogas. Thus—if the intention of § 95852.1.1(b) is to prevent crediting for biogenic CO_2 emissions—it is not only overbroad and confusing, but also unnecessary. If ARB believes that it is not sufficiently clear in the Livestock Offset Protocol that credits are not available for biogenic CO_2 emissions, *then it would be far better if ARB made the necessary modifications to the Protocol itself* rather than utilize the overbroad and confusing language currently in § 95852.1.1.

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Moreover, it would be helpful for this provision to make clear (as it does for RECs) that generation or use of offset credits from methane destruction projects under the Livestock Offset Protocol—and any future protocols that provide credit for methane destruction—will not prevent biomass-derived fuels from being exempt from compliance obligations.

For these reasons, we recommend the following revisions to this provision:

~~An entity may not sell, trade, give away, claim or otherwise dispose of any of the carbon credits, carbon benefits, carbon emission reductions, carbon offsets or allowances, howsoever entitled, attributed to the fuel production that would otherwise result in holding a compliance obligation for combustion CO_2.~~ Generation or use of Renewable Energy Credits or of offset credits that are available for methane destruction ~~is~~ are allowable and will not prevent a biomass-derived fuel that meets the requirements in this section from being exempt from a compliance obligation.

7. Remove the Requirement in the Livestock Offset Protocol that Every Destruction Device Have a Meter Installed.

Section 6 of the Livestock Offset Protocol reintroduces language that requires every destruction device to have a meter installed. This individual meter requirement will be onerous for small farms that currently have a number of generators with one meter on the main pipe running to the generation sets. Each individual meter costs $5,000, and there will also be on-going costs for maintenance and calibration. For instance, if one meter goes out of calibration it can cost as much as $1,000 to have it fixed, and the facility will lose the credits that were generated in the month or more it takes to fix the meter. Furthermore, as long as destruction devices are identical, a facility can demonstrate that they are operational by monitoring the performance of flares. This is done by looking at temperature readings which denote their operation. This use of temperature readings is an efficient and less costly proxy that maintains environmental integrity, and should be reintroduced in the final regulations.

8. Remove the requirement in the MMR section 95131(i) for additional verifications of biomass-derived fuels in the event of changes in suppliers or volumes.

MMR § 95131(i)(1)(A) requires an annual verification under which providers of biomass-derived fuels track and provide data on all volumes and entities involved in the production and transfer of fuel. Yet, § 95131(i)(1)(A)(1) and (2) also require a "full verification" any time there has been a change in the entity immediately upstream in the chain of title, or a volume increase of more than 25% from the immediately upstream

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entity. This second obligation imposes a very substantial and unnecessary burden. Changes in title and volume fluctuations can take place with relative frequency; more importantly, these occurrences might not take place in a predictable manner as the market for biomass-derived fuels develops. Undertaking a full-scale verification each time such events occur will be overly burdensome and expensive for many small fuel providers—especially considering that an annual verification itself could take several months to complete. The requirement for an annual verification of all relevant sources of supply and title holders will provide sufficient information for ARB without imposing unreasonable burdens. For these reasons, we urge ARB to require annual verifications only and remove § 95131(i)(1)(A)(1) and (2).

9. Make the Requirements for Wood and Wastes Consistent with the California Energy Commission's Requirements.

CERP generally appreciates the modifications and clarifications that ARB has made respecting emissions without a compliance obligation. However, we respectfully recommend that ARB modify the requirements that apply to wood and wastes so that they track those already established by the California Energy Commission (CEC).

Tracking of sources of wood and wood wastes is extremely difficult for covered entities and for agencies that do not have special expertise. For example, electricity generators burning wood waste meeting the CEC's definition of biomass[8] are not expected to have specific knowledge about the source of the wood being used in their operations. For this reason, enforcement of such requirements should be done with other agencies that already have oversight responsibilities of the harvesting of wood and wood wastes. Accordingly, we recommend the following revisions to section 95852.2(a)(4) to make it consistent with the CEC's definition of biomass:

(4) Wood and wastes <u>from timbering operations</u>~~identified to follow all of the following practices:~~

~~(A) Harvested pursuant to an approved timber management plan prepared in accordance with the Z'berg Nejedly Forest Practice Act of 1973 or other locally or nationally approved plan;~~

~~(B) Harvested for the purpose of forest fire fuel reduction or forest stand improvement; and~~

~~(C) Do not transport or cause the transport of species known to harbor insect or disease nests outside zones of infestation or quarantine zones identified by the Department of Food and Agriculture and the Department of Forestry and Fire Protection, unless approved by these agencies.~~

[8] "Renewable Energy Program Overall Program Guidebook," California Energy Commission, January 2011, at p. 19.

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D. Forestry

1. CERP Supports the Approach to Addressing Intentional Reversals in Forestry.

CERP is very supportive of the revised intentional forestry reversals language in section 95983(c)(3). This provision now provides that, in the case of an intentional reversal, ARB will seek replacement credits from the forest owner—the party responsible for the reversal. If the forest owner does not replace the credits, ARB will retire credits from the Forest Buffer Account and will subject the forest owner to enforcement action. This is a reasonable and balanced way to approach intentional reversals because it places the liability on the responsible party while ensuring that the environmental integrity of the program will not be compromised. If the forest owner does not replace credits as required, the credits can alternatively be taken from the Forest Buffer Account.

However, we are confused by the discontinuities between the forestry intentional reversals language and the invalidation provision regarding forestry. As written, the invalidation provision states in § 95985(g) that the Forest Owner must replace any ARB offset credit if it is found to be invalid pursuant to § 95985(b) and (d), and states that failure to do so will be considered a violation pursuant to § 96014. However, it is unclear whether § 95985(g) also incorporates § 95983(c)(3) and gives ARB to the authority to retire credits from the forestry buffer account if there is an invalidation of credits for reasons other than an unintentional or intentional reversal, or if ARB's sole recourse is to the forest owner to replace such credits. CERP requests clarification on this issue.

In addition, CERP recommends that the definition of "forest owner" in section 95892(103) be changed so that a forest owner does *not* include the owner of a conservation easement. This change had been made in the July 7th Discussion Draft, but it was reversed in the final July 25th package of 15-day changes. Altering this definition is important because it is all but inconceivable that the owner of a conservation easement would be responsible for harvesting or otherwise intentionally reversing a forest offset project—and therefore should not be at risk of bearing the significant liability that would result from such an act under the regulations. CERP agrees that forest owners should bear this responsibility, but feels that it is not appropriate to require the holder of a conservation easement to be similarly liable in the case of an intentional reversal.

2. CERP Supports Allowing Forest Projects On-site Visits Every Six Years.

With regard to the timing of forest verification, CERP appreciates ARB's responsiveness to the request that forest projects can have on-site visits just once every six

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years, as provided in § 95977(c). Such a change will reasonably reduce the large cost burdens of on-site verification of such projects.

3. Apply a Simplified Monitoring Regime for Years After the End of a Forestry Project's Crediting Period.

CERP recommends that ARB apply simplified verification and reporting requirements for a project after the end of its 25-year crediting period. After the crediting period, monitoring will play a different function: that of proving that stocks have not decreased from their levels in year 25 of the crediting period, and monitoring attendant natural forest management requirements. However as currently written, in sections 9.2.1 and 9.2.2, the regulations require the Offset Project Data Reports to contain a variety of information that is not relevant once the credits have been created, such as the application of a confidence deduction, if above 10%, for the inventory. In addition, a calculation of the forest buffer contribution or the GHG reductions are not applicable after the crediting period, and should not be required.

4. Clarify Whether Forestry Avoided Conversion Projects May Transfer the Land to Public Ownership as an Alternative to a Conservation Easement.

CERP requests clarification concerning whether Avoided Conversion projects implemented on public, non-federal land are required to obtain a conservation easement. Section 3.5 of the protocol states: "for Avoided Conversion projects *on private land* (emphasis added), the forest owner must record a Qualified Conservation Easement against the offset project's property in order for the forest project to be eligible." Section 3.6 provides that: "Avoided Conversion Projects must be implemented on private land, *unless the land is transferred to public ownership as part of the program*." (Emphasis added). Section 3.6 also specifies a number of steps that such projects on public, non-federal land must engage in, including public vetting processes sufficient to evaluate management and policy decisions. *However*, section 4 of the protocol states: "*All* lands in the project area must be covered by a qualified conservation easement." (Emphasis added). This language is ambiguous as to whether it applies to Avoided Conversion projects not only on private land, but also those on public land. CERP therefore requests that ARB clarify whether the transfer to public ownership is sufficient for Avoided Conversion projects. If so, such projects should not also have to have a conservation easement.

5. Apply the Requirement to Replace Issued Credits After Termination Only to Credits Issued in the Preceding Crediting Period.

Section 3.4 provides that, in the event of project termination, the Offset Project Operator or Authorized Project Designee must retire ARB Offset Credits issued for the

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project from the preceding 100 years. This language should be revised to clarify that the time period is focused only on the applicable crediting periods. Accordingly, we recommend deleting "preceding 100 years" and substituting "preceding crediting period(s)."

6. The Baseline Projection Estimation Requirement Should be for the Crediting Period, not 100 Years.

Section 6 of the protocol, which describes the general calculation of baselines for all types of forest projects, provides that modeling of the baseline must assume a 100 year period. The 100 year figure is repeated in the baseline calculation sections for each project type in § 6.1.1, § 6.1.2, and § 6.2.1. The 100 year time period is taken from the original Climate Action Reserve forestry protocol, and is sensible in that context because the CAR crediting period is 100 years. However, such baseline estimation is arbitrary in the context of a 25 year crediting period followed by a 100 year permanence period. Because projects can be renewed at the end of a 25 year crediting period, the project life is actually not known at the outset of the project. It would thus make sense to revise the protocol such that the initial baseline calculation is projected for the applicable crediting period. Then, if the project is renewed, the baseline would be recalculated as part of the renewal process. Accordingly, we recommend the following modification to Section 6 (and corresponding edits to the other sections):

> To establish baseline onsite carbon stocks, the carbon stock changes in each of the Forest Project's required onsite carbon pools (identified in Section 5.1 to 5.3) must be modeled over ~~100~~ the Forest Project's crediting period. Modeling must be based on the inventoried carbon stocks at the time of the Forest Project's ~~offset project~~ crediting period commencement.

7. Compensation for Intentional Reversals Should Apply Only to Reversals of Stocks for which Credits Have Been Issued.

Section 7 provides that all intentional reversals must be compensated. CERP respectfully requests that this requirement be modified so that the requirement applies only to the stocks for which ARB offset credits have been issued. Intentional reversals *after* the crediting period need not be compensated as long as the stocks that are associated with issued credit during the crediting period(s) are maintained for 100 years past the crediting period end. This interpretation is supported by other language in the protocol; for example, section 3.8.3, example 5, provides that reversals are permissible during the 100-year monitoring period as long as the stocks associated with issued tons are maintained. However, because this is not made explicit, CERP requests that it be more fully clarified in the protocol. Accordingly, we recommend the following modification to Section 7, subpart #2 (and corresponding edits to other sections):

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Permanence of forest project GHG reductions and removals is addressed through three mechanisms:

2. The regulatory obligation that all intentional reversals of GHG reductions and GHG removal enhancements, except those that occur after the crediting period and that do not reduce stocks below those associated with the issued tons, must be compensated for through retirement of other Compliance Instruments.

In a related note, section 7.2.2 provides that the buffer risk rating must be recalculated every year that a project undergoes verification. This language must be clarified to make clear that buffer contributions must be made for each year that a project is receiving credits, but not during the 100 year monitoring period (during which verification will also be required).

E. Deadlines in the Offset Project Process

1. CERP Supports the Modifications to the Reporting Period.

CERP supports the new definition of "Reporting Period" in § 95892(241) under which the period for initial reporting may be six to twenty-four months. CERP is also supportive of the changes in the regulations that allow the first Offset Project Data Report to be submitted within 24 months of listing the project, and annually thereafter. CERP further supports the change that specifies that data reports for all projects are not required to be submitted by a particular date each year, but rather are due four months after each (project-specific) reporting period, as provided in § 95976(d)(6). Section 95977(d) now requires that offset verification statements are to be submitted within nine months after the conclusion of each Reporting Period, which CERP believes is a reasonable deadline. These modifications are more reasonable, and will avoid the bottlenecks caused by requiring all projects to undertake reporting simultaneously every year.

2. Allow Reasonable Extensions of the Report Deadline.

Though CERP appreciates the more reasonable period in the revised regulations for submitting reports, the requirement in § 95977(d) that states a project will not be eligible for registry offset credits if the deadline is missed is far too harsh a response when there may be a good faith reason for delay. For this reason, CERP urges ARB to include in the regulations a provision authorizing the agency to provide deadline extensions on the basis of specified reasons. Such reasons could include:

- A verification is delayed because the verifier is working on too many projects.

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- A verification is delayed because the relevant Offset Project Registry loses its approval and the project must switch to another registry.

- A contracted verifier ceases to provide verification services.

- A verifier determines that a qualified positive verification statement is likely appropriate but will require consultation with ARB or the approved offset registry and/or the collection of further data to support the qualified positive verification statement.

- Data that must be submitted in an Offset Project Data Report must be obtained from a third party and the third party (or the third party's equipment) is responsible for the delay (e.g., meter malfunction).

- A verifier determines that additional data must be collected to meet important data quality standards (e.g. delays due to additional or repeated sampling of plots in a forestry project to improve statistical confidence).

- A decision by ARB or an Offset Project Registry is appealed by an Offset Project Operator or a verifier.

- A decision by a verifier is appealed by an Offset Project Operator.

- A verifier or an Offset Project Operator requires clarification on a protocol or its applicability to a specific project from ARB or an approved offset project registry.

- Project data collection or required verification site visits are delayed because the project site cannot be accessed (e.g. due to inclement weather) or because data collection equipment must be repaired or replaced.

3. Add a Deadline for ARB to Determine that a Report is Complete.

CERP supports the addition of deadlines in the regulations for ARB to take action on a report that the agency has determined is complete (see § 95981.1). However, there is no deadline for ARB to make the threshold completeness determination; the absence of such a deadline will add uncertainty and costs to the process. The absence of a deadline also deprives interested parties of any recourse in the event that ARB is dilatory. Accordingly, CERP respectfully requests that ARB have no more than 30 days to make such a determination.

F. General Issues Related to Verification

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1. Avoid Discontinuities Between the Main Regulations and the Protocols with Respect to Verification Requirements by Keeping Project-Specific Requirements in the Protocols.

In a number of instances, the main regulations and the individual protocols impose overlapping but different verification requirements that are particular to a specific offset project types. For example, § 95976(a) provides that meters for livestock offset projects be maintained and calibrated at a frequency required by the manufacturer. However, the Livestock Offset Protocol states that meters may be calibrated more frequently than manufacturers' recommendations; in addition, the protocol requires more frequent inspections.

This type of confusion between the main regulations and the protocol could have significant adverse impacts on the program by leading to delays and disputes. In particular, these discontinuities could result in significant disarray if ARB continues to require invalidation of all offset credits from a data report if it is not "accurate."

We recommend that protocol-specific requirements be left in the protocol, and not addressed separately and different in the main regulations. We urge ARB to review the regulations to identify and eliminate overlapping provisions.

2. Remove Unnecessarily Prescriptive Verification Requirements.

CERP strongly believes that a sound system of independent project verification is the bedrock for environmental integrity in the offsets program. However, we have grown concerned that the verification-related regulations have become overly and unnecessarily restrictive. The regulations now go beyond what is needed to safeguard environmental integrity, reaching a point where the burdens and costs will dissuade the development of even the highest-quality projects. Already, the Climate Action Reserve process takes an average of three months to navigate; the additional layers imposed by the ARB regulations will mean that many projects will be approaching the nine month "hard" deadline for data reports. In other words, it is an example where the perfect is the enemy of the good.

For example, § 95977.1(b)(3)(R)1 requires that verification reports be scrutinized by a different independent *person* each time. In our view, this requirement is not practical, workable—or necessary. It is very possible that, after two or three projects, a verifier will no longer have the staff to verify projects if this requirement for different, independent parties is applied.

Further, the requirement in § 95977.1(b)(3)(R)4(d) for verifiers to have "a final discussion with the Offset Project Developer" is also, based on our experience, unnecessary. We strongly suggest that this requirement be eliminated.

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In addition, § 95977.1(b)(3)(D) requires verifiers to make a site visit every year. We suggest that the requirement could be made more flexible, while still achieving the same purpose, if verifiers were required to undertake a site visit within two months of the end of the reporting period.

Finally, we strongly urge ARB to recognize that small-scale projects cannot and should not have to carry the full verification burdens borne by larger projects. In particular, we recommend that ARB allow projects below a certain ton threshold to undertake a site-visit verification every *two years* instead of annually (the project still could report annually). CERP recommends a threshold of 25,000 metric tons CO_2e/yr for this threshold. This is the same threshold ARB uses for reporting of emissions by sources. A lower threshold (such as 10,000 tons) would be too small; many Offset Project Operators would have to do a significant amount of work even to determine whether they meet such a lower threshold. By contrast, 25,000 tons/yr is an appropriate, established, and credible threshold for what constitutes a small-scale project that should merit a once-every-two-years site visit rule.

G. Approved Offset Project Registries

1. CERP Supports the Extension of Offset Project Registry Approval to 10 Years.

CERP is supportive of the revisions to the regulations in section 95986(j)(5) that extend Offset Project Registry validity from five years to ten years.

2. Allow ARB to Extend Crediting Deadlines for Projects that are Required to Re-submit to a New Offset Project Registry.

CERP is generally supportive of the regulatory process for projects in a registry that subsequently loses its approval, as explained in § 95986(k)(3). Under the revised regulations, any projects in a registry that subsequently loses its approval have to re-submit with a new registry or with ARB, but get to keep their originally approved crediting period.

CERP is concerned, however, about what will occur if a project resubmitting its information to a new registry misses a deadline for a reporting its reductions. The regulations suggest that in this case the crediting year may simply be lost. CERP recommends modifying § 95986(k)(3) as follows so that it is clear that a project may have an extension of relevant crediting deadlines if the re-submission process is time-consuming:

> (3) An Offset Project Operator or Authorized Project Designee who has been notified by an Offset Project Registry of a suspended or revoked approval

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must re-submit its project information with a new Offset Project Registry or ARB. An offset project listed at ARB or a new Offset Project Registry will continue to operate under its originally approved crediting period, provided that ARB may extend the crediting period or the relevant deadline in § 95977(d) for one year if ARB determines that such extension is necessary to provide time for re-submission of information to the new Offset Project Registry or ARB.

H. Conflict of Interest Requirement for Use of Verifiers

1. CERP Supports the Clarification that the Rotation of Verifiers is Based on the Individual Project, not the Project Operator.

CERP commends ARB on the changes to the verifier replacement requirements in section 95977.1(a). Such revisions make clear that the six-year rotation of verifiers is based on the individual project, not the project operator. This clarification is helpful in reducing the administrative burden of the verification process. It will allow the Offset Project Operator to utilize the same verifier for multiple projects, provided that the verifier for any particular project changes every six years. This change will avoid the very high and unnecessary transaction costs that would result from requiring Operators to contract with a large number of verifiers at once, especially in a market where the overall number of verifiers is expected to be small.

I. Record Retention

1. CERP Supports Record Retention for 15 Years.

CERP is supportive of the revised regulations on record retention in § 95976(e)(2), which now provide that the document retention period for all projects is 15 years following the issuance of ARB offset credits related to the relevant report.

J. Compliance Penalty

1. Allow Covered Entities to Use Offset Credits to Pay the Compliance Penalty.

Section 95857(b) provides that in the event of an untimely surrender of compliance instruments the required excess payment of compliance instruments can only be fulfilled by allowances. CERP believes this is unnecessarily restrictive and urges ARB to alter the language so that any kind of compliance instrument—including offset credits—may be used to satisfy the excess payment. We see no reason to limit the excess payment to

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allowances. Authorizing use of both allowances and offsets will reduce the adverse impact on the broader marketplace from this penalty requirement.

III. BUYER LIABILITY

A. The "Buyer Liability" Approach to Managing Offset Risk is Neither Fair Nor Efficient.

Our greatest concern relates to ARB's approach to addressing situations in which ARB finds a discrepancy with respect to an offset project after the agency already has issued credits for the project. To be clear, we agree with ARB that the risk that projects lacking in environmental integrity will be issued credits will be very small given the rigor of the regulations, protocols, and the system of verification. However, we also agree that it is important to have a fair, efficient, and reliable approach to making the program whole in the event of such outcomes.

The current regulations address this risk through what is referred to as "buyer liability."[9] Under this approach, if ARB finds *any* discrepancies associated with an already-issued offset credit, it requires the holder or user of the credit to replace it with another compliance instrument within 90 days or face severe penalties. We and many others have identified problems with the "buyer liability" approach, and have supported an alternative—a compliance buffer account. (See Appendix C for the compliance buffer account proposal previously provided to ARB by CERP and a number of other organizations.)

Our central point is that *any policy under which already-issued offset credits can be invalidated will prevent the development of a market in offsets.* The marketplace will not deal in instruments that are shadowed by the risk of invalidation and penalties. ARB's buyer liability rule will impose costs and risks on the offsets program that will strongly discourage the use of offsets and drive the program far closer to the "no-offsets" scenario—and, yet, *will not provide any greater environmental integrity* than a compliance buffer account or other similar approach that involves setting aside credits that can be retired in the event of offset credit problems.

In particular, the current proposed regulations require ARB to invalidate 100% of the offset credits issued for a project in a particular year if it determines that the Offset Project Data Report for that year was not "true, accurate, or complete." There is no materiality condition associated with this requirement. In other words, a minor inaccuracy or omission in a project's paperwork will cause ARB to invalidate all of the credits issued for the project—*even if all of the emission reductions achieved by the project were 100% real, additional, and verified.* This establishes an impossible, unfair, and unnecessary condition

[9] *See generally* § 95985.

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for offset projects—particularly in light of the extensive and detailed requirements for verification of projects (the general regulations include 18 pages of verification requirements, which do not include the additional requirements in the project-specific protocols).

There are several flaws with the buyer liability system. First, the approach is not fair. To be fair, a liability system should impose liability on the party actually responsible for the default. In the case of offset discrepancies, it almost certainly will be the offset project operator, the verifier, or the offset project registry that is at fault—and, under the cap-and-trade regulations, each of these parties makes attestations and submits to the jurisdiction of ARB. By contrast, the buyer of a credit will rarely if ever be responsible for a discrepancy related to offset credit issuance. Yet, under ARB's proposed buyer liability rules, the holder or user of a credit is presumptively liable. Liability shifts to the offset project operator only if the holder or user of the credit is no longer in business. This arrangement turns fairness on its head. To be clear, even most project developers would prefer a liability system in which liability rests with the party actually responsible for the discrepancy. (Indeed, ARB has adopted precisely this approach in the case of intentional reversals of forest projects, which we applaud.)

In addition, the buyer liability approach is highly inefficient. To be efficient, a liability system should impose liability on the party that has the most information and ability to control performance. Again, it is the offset project operator, verifier, and registry that have the greatest ability to avoid discrepancies—not the current holder of the offset credit. Accordingly, the buyer liability approach imposes additional and unnecessary transaction costs on the buyer of credits to protect itself against invalidation.

We outline further flaws with the buyer liability system below.

B. Forcing Buyers to Bear the Liability for Offset Credit Discrepancies Will Not Help Reduce Such Discrepancies.

Some ARB officials have expressed a view that the buyer liability approach will reduce the risk of offset credit problems by creating incentives for buyers to scrutinize and avoid problematic sellers of offset credits. This view does not reflect the reality of how an offsets market works.

To be sure, covered entities have ample reasons to seek out scrupulous and competent sellers of offset credits—even without a buyer liability rule. Mainly, covered entities want to be assured that a seller is the kind of entity that will follow through on *delivery* of credits that are issued. However, covered entities are not well positioned to develop the kind of understanding of projects to allow them to discern whether claims of reductions are valid and that the project paperwork is 100% free of any errors. Companies that are in the business of electricity generation, refining, or cement manufacturing, for

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example, do not have any special insight into the business of methane digesters, ozone-depleting substances, or forestry. In an offsets market, these companies will rely on the work of verifiers—and on ARB itself as credit issuer.

For this reason, making buyers liable for errors not detected by verifiers or the ARB itself will impose a substantial new cost and risk on buyers without materially reducing the risk of such events occurring. Buyers do not have added ability to avoid these events, short of incurring the costs of obtaining a second complete verification. If ARB truly seeks to reduce the risk of such occurrences, it should impose liability on the party actually responsible.

C. Relying on Buyers to Mitigate Buyer Liability Through Contracts Will Result in High, and Unnecessary, Costs on the Offsets Program.

Some ARB officials have asserted that buyers can easily manage their liability risk by entering into contracts with offset project operators that force the latter to pay penalties for invalidated credits. However, this view is not consistent with marketplace realities. Managing the risk through contracts is not feasible.

Such contractual provisions will unleash a chain of contractual claims involving not only the buyer and the offset project operator but also every other party that held custody of the invalided offset credit prior to it being invalidated. The buyer will turn in the first instance to the party that sold the invalidated offset credit to it; this party will then go to the party from whom it received such credit; and so forth down the chain until the offset project operator is reached. Each receiving party of the invalidated offset credit will seek to enforce a contractual claim for damages on the delivering party. Resolving this chain of claims will be hugely time-consuming and costly; it will paralyze the market, and strongly discourage covered entities (especially small businesses) from ever venturing to buy offsets at all.

These outcomes will have seriously adverse effects on the offset program. In effect, aggregators, who intermediate between covered entities and offset project operators by sourcing and developing projects and sell the resulting offset credits to covered entities, will be forced out of the market. This is because no aggregator will guarantee delivery of offset credits to a buyer if there is a possibility that the aggregator will face a contractual claim against it in the event an offset credit is invalidated for reasons beyond its control.

The exit of aggregators will have real consequences. Aggregators play the crucial role of providing covered entities—especially small-and medium-sized businesses that have limited resources—with offsets credits to which they would not otherwise have access. Managing offset credits requires technical expertise and infrastructure that is costly to maintain, and generally beyond the ability of all but the largest covered entities. If

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aggregators are foreclosed from the market, then far fewer covered entities will use far fewer offsets.

Without aggregators, the offsets market will consist, if it exists at all, of bilateral arrangements between covered entities and individual projects. Even bilateral contracts will require covered entities to count on enforcing these contracts several years into the future. In reality, it is very difficult and costly for covered entities to rely on contract clauses to "carry" for eight years the risk that they suddenly will face a 90-day clock to replace credits.

Such bilateral deals will be manageable only by the largest covered entities, and such entities will be interested only in the largest projects. Covered entities likely will not find it worthwhile to deal with smaller projects—which are the kinds of projects likely to be located in California.

With such a stunted offsets program, allowance prices will necessarily increase in order to provide incentives for the more costly abatement needed to meet the cap. In the end, we will be much closer to the "no-offsets" end of the spectrum.

D. Economically Viable Insurance Products Will Not Emerge to Manage Buyer Liability.

Some ARB officials have said they see insurance products emerging to fill the gap—and say that some insurance companies already have come to the agency with a "build it and we will come" message. Based on what we have learned about conversations with insurance companies about the California offsets program and our experience with insurance in other markets, we are much more skeptical. We have concluded that, for the following reasons, economically viable insurance products are not likely to emerge under a buyer liability regime.

First, insurers generally are confounded by the area of government-issued offsets. Insurers typically assess and insure against risks that apply to activities or enterprises. In an offsets market, by contrast, the relevant risk relates to the performance of a government program—and, in the case of the ARB offsets system, a government program with no track record of experience. Like most buyers of credits, insurers have no particular insight into the risk of measurement errors made by an ARB-accredited verifier or an offset public registry. To be sure, they could pay the cost of a second, independent verification for each project, but that would be a significant cost. For these reasons, if insurers have to individually insure each project—and be ready to pay claims on that insurance for upwards of eight years—such insurance will be cost-prohibitive.

In other types of more mature and "natural" markets, the cost of insurance can come down if offered on the basis of large pools, in which case invalidation risks can be spread

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among numerous and diverse activities or individuals. However, there is no mechanism in the offset regulations that makes such pooling possible for private insurers. As a result, any insurers for the ARB offsets market will have to build up such pools on their own over time and at very high cost—and these costs will be passed through to covered entities in their rates.

In addition, in order to be prepared to pay out on claims, each insurer will have to amass a buffer account of allowances and offset credits. This means that there will be additional players in the market buying up allowances and offset credits and passing the costs of these purchases through to covered entities in insurance rates. Carbon prices will also be higher than they would otherwise be because there will fewer allowances and offset credits available to covered entities to use for compliance because of this additional buying by insurers to maintain their own buffer accounts.

Finally, even where such insurance becomes available, our members' experience is that insurers will refuse to cover "market risk." In other words, if the market price of offset credits increases from the time the insurance is purchased, insurers will not cover that difference. Thus, even "high-end" insurance products will fall short, forcing buyers of offset credits effectively to self-insure for some portion of their risk.

We have noted that the proposed regulations now authorize offset project registries to offer (but not mandate) insurance. However, for at least two reasons, it is our view that registries will not provide a workable insurance pathway. First, registries have a conflict of interest. As ARB's own regulations recognize, registries themselves could be the source of a credit discrepancy.[10] Second, registries are not well capitalized, and therefore could not be relied upon to pay out on claims. Without a balance sheet, a registry would not be in a position to play the role of insurer.

Accordingly, experience suggests that viable and economical insurance products will not materialize under the buyer liability regime proposed by ARB. The insurance products that do emerge will be available only at very high prices, which will severely impair the ARB offsets program. The need to obtain high-priced insurance will amount to a substantial and unnecessary cost to the offsets program, crowding out small projects and small businesses. Far fewer offset credits will be used in the program, including from offset projects that otherwise could pass all of the program's environmental rules with flying colors. Again, this outcome will drive the regulations far closer to the "no-offsets" side of the cost spectrum.

[10] *See* § 95985(b)(1) (providing that a grounds for invalidation includes a determination by ARB that "information provided to ARB for an Offset Project Data Report or Offset Verification Statement by offset verifiers, verification bodies, Offset Project Operators, Authorized Project Designees, or *Offset Project Registries,* related to an offset project was not true, accurate, or complete") (emphasis added).

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E. The Buyer Liability Approach Will Distort a Western Climate Initiative Market.

For the foregoing reasons, covered entities and other buyers will avoid offsets issued by ARB if they carry with them the risk of later invalidation. This avoidance could have significant implications in the event that California ultimately links its program with other Western Climate Initiative (WCI) jurisdictions. If one or more of the other WCI jurisdictions adopts a different approach to addressing post-issuance offset discrepancies, then covered entities throughout the WCI will gravitate to offsets issued by those other jurisdictions. This will distort the efficiency and effectiveness of a broader WCI market. It also will mean that buyers will steer way from projects based in California.

F. ARB Should Apply the Forest Buffer Account Approach to All Offsets.

In our view, any approach to managing offset invalidation should meet four criteria: (1) it should ensure that the program is made environmentally whole; (2) it should be fair; (3) it should minimize costs to the offsets program; and (4) and it should minimize administrative burdens on ARB. For the reasons discussed above, the buyer liability approach may meet the first criterion, but substantially flunks the second two. Furthermore, it is not clear to us whether it imposes reasonable burdens on ARB because the effectiveness of buyer liability relies on ARB carrying out successful enforcement actions against potentially multiple buyers of credits from an affected project.

We and many others have advocated that ARB adopt an alternative approach: a compliance buffer account. ARB's expressed hesitations about this approach seem to us to underestimate the adverse impacts of the buyer liability approach and overestimate the administrative burdens and risks borne by ARB under a compliance buffer account approach.

In any event, we note that the proposed revisions to the regulations suggest that ARB is willing to adopt a variation on the compliance buffer account in the case of forest offsets. Though the approach does not conform precisely to the compliance buffer account mechanism supported by ourselves and others, we would greatly prefer ARB's use of this approach to the buyer liability system.

Under ARB's proposed regulations, ARB will hold back a certain amount of credits from each issuance of credits to a forest project. It will place these credits in a Forest Buffer Account. In the event of an "unintentional reversal" affecting the forest project, the already-issued credits will remain valid, but ARB will retire a corresponding number of credits in the Forest Buffer Account. In the event of an intentional reversal, the already-issued credits again will remain valid, *and ARB will require the forest owner* (not a buyer) to deliver a corresponding number of compliance instruments credits from the forest owner

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(not the buyer). If the forest owner does not provide replacement instruments, ARB will cancel credits in the Forest Buffer Account.

We respectfully urge ARB to apply this approach for all offset projects. Compared to the buyer liability system, this approach would be: (1) equally effective in making the system whole in the event of invalid credits; (2) far fairer (by holding "bad actors" liable where possible); and (3) much more efficient (by effectively putting in place a system-wide, socialized insurance backstop). ARB has provided no reason that this kind of approach is workable and appropriate for forest offset projects, but not for other offset project types.

In particular, ARB has not explained why extending this approach to all offset projects establishes an unreasonable administrative burden on the agency. We do not believe such a burden would result. The primary role of ARB under the buffer account approach is to determine the portion of offset credits to set aside in the account. We believe this set-aside should be conservative. In any event, ARB would have the ability to increase the amount of the set-aside if the buffer account runs low.

Some ARB officials seem to have impression that "management" of the buffer account itself would impose burdens on the agency, and even require the employment of additional staff. This is incorrect. Once the set-aside amount is determined, the buffer account only exists for the purpose of retiring credits—which is an all but automated response to a finding of invalidation. The account requires no active management. It is not a bank account.

For these reasons, we urge ARB to expand the Forest Buffer Account concept to all offset credits. Proposed regulatory language to effect this change is in Appendix B.

G. Recommended Modifications to the Credit Invalidation Rules.

Regardless of whether ARB adopts a buyer liability approach or buffer account approach to addressing offset credit invalidations, it is important to ensure that the grounds and process for invalidation are well designed.

We appreciate and welcome many of the modifications and clarifications that ARB added to the invalidation procedures—including the establishment of a statute of limitations; establishment of a process for notification and exchange of information among buyers, offset project operators, and ARB; delineation of the grounds for invalidation; and a clarification that mere inconsistency of the project with an updated protocol will not be a reason for invalidation.

However, we urge ARB to consider the further modifications outlined below, which we believe will continue to promote environmental integrity while moderating the costs and risks imposed on the offset market.

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1. Limit the Statute of Limitations to the Earlier of Eight Years or Finalization of a Second Verification.

In the current proposal, ARB has added a statute of limitations of eight years for invalidation of already-issued offset credits. In addition, it appears that a project can shorten the statute of limitations to five years if it undergoes a second verification after three years of issuance of the credits.

According to this yardstick of credibility, ARB considers the validity of offset credits sufficiently established after the project has been reviewed by a second, independent ARB-accredited verifier and the second verifier has not identified any grounds for validation as set forth in § 95985(b).

We believe this is a well-grounded approach. Also, it provides a basis for minimizing the most problematic aspect of offset liability: the extended period of time during which an already-issued offset credit remains subject to invalidation. In particular, we think it would lead many entities in the offsets market to manage their risk by obtaining a second verification of each data report immediately following the issuance of credits—which would bolster the credibility of the program.

To this end, we urge ARB simply to allow the invalidation period to expire upon the date of ARB's acceptance of the second verification. We see no reason to require that a second verification "sit" for five years before lifting the shadow of invalidation. Nothing is gained from the passage of time—and yet, the marketplace will not consider the credit valid and marketable for the length of that period.

2. Remove the Liability for Offset Project Data Reports that are not "True, Accurate, or Complete" Because it is Unreasonable and Addressed by the Other Liability Conditions.

We urge to ARB modify the provisions under which offset credits may be invalidated. Currently, these include four conditions: the project information is not "true, accurate, or complete" (§ 95985(b)(1)); the project documentation contains errors such that emission reductions achieved by the project are overstated by 5% or more (§ 95985(b)(2)); the project did not meet all applicable legal requirements (§ 95985(b)(3)); and a finding that credits already have been issued for the project in another program ((§ 95985(b)(4)). We respectfully request that ARB eliminate (b)(1). Given the myriad requirements of the offset regulations, any number of projects could have documentation that has inadvertent inaccuracies or omissions. Yet, under this vague and overbroad provision, a minor paperwork problem could result in invalidation of 100% of the offset credits already issued for a project—*even if there was no impact on the reductions or removals actually achieve by the project*. This is a draconian, "gotcha" approach that will

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deter development of offset projects for reasons unrelated related to environmental integrity. Furthermore, any discrepancies that *do* have material effects on the environmental integrity of the project are completely addressed by (b)(2), (3), and (4). For these reasons, we respectfully urge ARB to eliminate (b)(1).

Accordingly, we recommend the following edits to the regulatory language (which also include the edits recommended in section G.1 above)

(a) ARB may determine~~, within 8 years of issuance, except as provided in section 95985(b)(5) and 6, that an ARB offset credit is invalid for the following reasons:~~ at any time until the earlier of (i) a post-issuance verification of the Offset Project Data Report by a different offset verifier and (ii) 5 years ~~of~~ after issuance, that:

~~(1) ARB determines that information provided to ARB for an Offset Project Data Report or Offset Verification Statement by offset verifiers, verification bodies, Offset Project Operators, Authorized Project Designees, or Offset Project Registries related to an offset project was not true, accurate, or complete; or~~

~~(2)~~(1) The Offset Project Data Report contains errors that overstate the amount of GHG reductions or GHG removal enhancements by more than 5 percent (in which case, ARB shall determine the amount of offset credits that corresponds to the overstatement); or

~~(3)~~(2)The offset project did not meet all local, state, or national regulatory requirements during the time covered by an Offset Project Data Report; or

~~(4)~~(3)ARB determines that Offset credits have been issued in any other voluntary or mandatory program within the same offset project boundary or for the same GHG reductions or GHG removal enhancements covered by an Offset Project Data Report.

~~(5) If an offset project is developed under Compliance Offset Protocol U.S. Ozone Depleting Substances Projects, ARB may invalidate within five years of issuance of the ARB offset credits covered by an Offset Project Data Report.~~

~~(6) If an offset project is verified after three years of ARB offset credit issuance by a different offset verifier, ARB may invalidate within five years of issuance of the ARB offset credits covered by and Offset project Data Report~~

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~~(7)~~(4)An update to a Compliance Offset Protocol in itself, will not result in an invalidation of ARB offset credits issued under a previous version of the Compliance Offset Protocol.

3. Limit Liability from "Overstatement" to the Extent of the Overage.

We urge ARB to revisit the provisions related to "overstatement" to avoid unnecessarily punitive outcomes.

The rules provide that one of the grounds of invalidation of offset credits is a finding that an offset project data report "overstate the amount of GHG reductions or GHG removal enhancements by more than 5 percent"—irrespective of whether such overstatement resulted from malfeasance or good faith error.

It is unclear from the rules themselves what penalty flows from such an occurrence. However, we have learned from ARB staff that a finding of more than 5 percent overstatement will result in invalidation of all of the credits issued in connection with the data report. *In other words, in the event of an overstatement of 6%, ARB would invalidate 100% of the credits associated with the report—even though 94% of the reported reductions would be real, additional, and verifiable.* It is this kind of draconian rule that will dissuade many entities (and insurers) from even participating in the offsets program.

ARB officials have explained that they have adopted this approach because the invalidation system only includes a step in which there is a *general* determination of material misstatement, and does not include a second step of determining the *specific* amount of the overage. We believe that it is only consistent with due process and fairness to penalize only the actual overage. We would support adding a step in the process that make such a precise determination of liability possible—even if it necessitates required cooperation by the offset project operator and a new verifier.

ARB officials also have said that they are reluctant—under a buyer liability system—to penalize only some holders of credits from a particular year and not others. Yet, such an outcome is not necessary. If ARB retains the buyer liability approach—which, again, we strongly oppose—we recommend that ARB apply the overage penalty on a *pro rata* basis to all holders of credits from the relevant vintage year. See the following example:

a. For a particular offset project, two entities are holders or users of credits issued in a particular vintage year: Entity A (60% of credits) and Entity B (40% of credits).

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b. ARB subsequently finds a material misstatement for the project of 1000 tons.

c. ARB invalidates 600 of Entity A's credits and 400 of Entity B's credits.

We believe such a *pro rata* approach is fair and efficient.

4. Allow Responsible Entities Six Months to Replace Compliance Instruments.

We appreciate that ARB has extended the period of time from 30 days to 90 days that an invalidated credit must be replaced.

Firstly, we believe that it should be the responsibility of the project owner or other relevant entity that committed the error (not the buyer) which leads to the invalidation to replace the offsets credits, as discussed above.

Secondly, 90 days remains a very tight timetable for any entity to obtain replacement credits, particularly if it must obtain a large quantity. We respectfully urge ARB to further lengthen this period, and we do not believe that a longer period would impose any particular added burden on the program—or the climate.

To this end, we note that the regulations allow *six months* in the event of under-reporting of emissions for a covered entity to surrender additional compliance instruments.[11] Furthermore, in the context of an intentional reversal in a sequestration project, the regulations sensibly provide a year to determine the extent of the reversal.[12] It is unclear why there should be a far shorter period in the context of an ARB determination of offset invalidation under § 95985(f), and therefore respectfully urge ARB to modify the relevant provisions.

IV COMMENTS ON OFFSET SUPPLY ISSUES

A. ARB should move quickly to promulgate additional offset protocols in order to provide a sufficient level of potential offset credits.

CERP understands that ARB may not add additional project types and protocols as part of a 15-day package. However, we encourage ARB to take expedited action separate from this 15-day package to finalize new protocols. Such new protocols will be crucial for ensuring sufficient supply of offsets in the cap-and-trade system.

[11] Section 95858(c)
[12] Section 95983(c)(3).

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To this end, and in order to facilitate planning, CERP requests that ARB make additional information on the schedule for consideration of new offset protocols public. It would be helpful if ARB announces a date for the offset workshop on new protocols, and signals when those engaged in the market can look forward to seeing such new protocols introduced.

CERP stresses that offset projects take significant time to complete and therefore new offset protocols must be introduced as early as possible so that project development may begin in a timely manner and offset credits may begin to be generated. The need for timely introduction of protocols is especially great because the Western Climate Initiative (WCI) has issued draft guidance[13] that, if finalized, will require a new protocol to go through public comment processes both on the WCI level and in individual member jurisdictions, which will be extremely time-consuming and generally uncertain. The disclosure of further information regarding ARB's process and timing is especially important to project developers who are trying to determine whether to invest significant capital in new project types and who need signals concerning what protocols will likely be accepted and able to earn ARB credits.

Even if ARB can only provide a tentative indication of protocols under consideration, such a message can be helpful. The market is comfortable making advance investments around such conditional information.

CERP also requests that ARB make additional information public concerning the process and proposed timeline for setting up the offsets registry and the accreditation of verifiers, as well as the listing of offset projects. It is our understanding that many of these activities will be occurring during 2012 as the cap-and-trade system gets up and running, but before the compliance obligation begins in 2013. Any new information that ARB can provide the public with regard to their process for offset system development will be helpful in preparing the cap-and-trade market to begin operation.

B. ARB Should Accelerate Development of REDD Protocols and Include Additional Sub-national Entities.

Study after study shows that, even with the promulgation of additional protocols, the supply of offsets is well short of demand until the protocols for Reducing Emissions from Deforestation and Degradation (REDD) projects come on line. For this reason, CERP strongly urges ARB to accelerate the process of development of these protocols.

Further, we recommend that ARB expand the list of sub-national regions that can participate in the protocol development process and host projects. ARB's current process unreasonably excludes Brazilian states, such as Pará, that have expressed strong and direct

[13] Draft Offset Protocol Review and Recommendation Process, Western Climate Initiative, July 14, 2011.

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interest in working with California, and that are currently working with high-quality, high-integrity projects. We urge ARB to bring such states, including Pará, into the fold.

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V. CONCLUSION

We appreciate your consideration of our comments. Please let us know if you would like to discuss these concepts, or would like further explanation of any of these points or suggestions. We look forward to continuing to work with you to ensure that the California offsets program is effective, efficient, and environmentally rigorous.

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Appendix A

Members of the Coalition for Emission Reduction Policy (CERP)

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The Eco Products Fund
PG& E
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Deutsche Bank
Duke Energy
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Appendix B

Proposed Modifications to the Regulatory Language to Address Offset Credit Invalidation

Modifications to §95802. Definitions

This modification would establish an Offset Buffer Account. The language mirrors the existing language for the Forest Buffer Account.

(167) "Offset Buffer Account" means a holding account for ARB offset credits. It is used as a general insurance mechanism against failure to surrender additional compliance instruments when ARB has made a determination pursuant to Section 95985 (f).

(Renumber definitions accordingly)

Modifications to §95831. Account Types

This modification would establish that the Offset Buffer Account is one of the accounts under the control of the Executive Officer. The language mirrors the existing language for the Forest Buffer Account.

(b) Accounts under the Control of the Executive Officer. The accounts administrator will create and maintain the following accounts under the control of the Executive Officer.

. . .

(7) A holding account to be known as the Offset Buffer Account:

(A) Into which ARB will place offset credits pursuant to section 95981.1; and

(B) From which ARB may retire ARB offset credits pursuant to section 95985 and place them into the Retirement Holding Account.

Modifications to §95981.1. Process for Issuance of ARB Offset Credits.

This modification adds a step to the credit issuance process under which ARB would hold back a portion of credits and place them in the Offset Buffer Account. The

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language mirrors the existing process for the Forest Buffer Account, but allows ARB to specify the percentage of the hold-back and provides a recommended percentage. It also allows ARB to increase or decrease the percentage to ensure that the amount of credits in the Offset Buffer Account is sufficient to address any invalidations.

(g) Offset Buffer Account. A portion of ARB offset credits issued to an offset project will be placed by ARB into the Offset Buffer Account.

(1) The amount of ARB offset credits that must be placed in the Offset Buffer Account shall be **[1.5%]** of the amount issued to a project; provided that ARB shall increase this percentage if ARB determines that the amount of offset credits in the Offset Buffer Account is less than **[1.5%]** of the number of offset credits issued in the previous five years, and ARB shall decrease the percentage if the amount in the Offset Buffer Account is more than **[1.5%]** of the number of offset credits issued in the previous five years. Any such modification to the percentage placed in the Offset Buffer Account shall apply to offset projects listed or starting a new crediting period after the date of the modification.

(2) ARB Offset credits will be transferred to the Offset Buffer Account by ARB at the time of ARB offset credit registration pursuant to section 95982.

(3) If an offset project is originally submitted through an Offset Project Registry, an equal number of registry offset credits must be retired by the Offset Project Registry and issued by ARB for placement in the Offset Buffer Account.

Modifications to §95985. Invalidation of ARB Offset Credits.

These modifications would do the following:

- ***Reduce the statute of limitations for invalidation to the earlier of 8 years and the date that the project obtains a second verification.***
- ***Eliminate from the conditions that could lead to invalidation a finding that the project documentation was not "true, accurate, or complete." This condition is overbroad and unnecessary given that there are other conditions that address errors that overstate emissions and failure to comply with legal requirements.***
- ***Clarify that all entities involved with a project will be notified of a finding of invalidation.***
- ***Require ARB to identify the entity responsible for the condition that resulted in identification.***
- ***Require the responsible entity to provide replacement credits or face penalties. If the responsible entity fails to provide replacement credits, ARB will retire a***

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corresponding amount of credits in the Offset Buffer Account. This language mirrors the existing language for the Forest Buffer Account.

- ***Allow the responsible entity six months (instead of 90 days) to replace credits; this approach is consistent with the provisions on liability for under-reporting of emissions.***

(a) An ARB offset credit issued under this Article will remain valid ~~unless invalidated pursuant to sections 95985(b) and (c).~~ provided that, if ARB makes a determination pursuant to section 95985(b) then an additional compliance instrument must be surrendered in accordance with sections 95985(e).

(b) ARB may determine~~, within 8 years of issuance, except as provided in section 95985(b)(5) and 6, that an ARB offset credit is invalid for the following reasons:~~ at any time until the earlier of (i) a post-issuance verification of the Offset Project Data Report by a different offset verifier or (ii) 5 years ~~of~~ after issuance, that:

~~(1) ARB determines that information provided to ARB for an Offset Project Data Report or Offset Verification Statement by offset verifiers, verification bodies, Offset Project Operators, Authorized Project Designees, or Offset Project Registries related to an offset project was not true, accurate, or complete; or~~

~~(2)~~(1) The Offset Project Data Report contains errors that overstate the amount of GHG reductions or GHG removal enhancements by more than 5 percent (in which case, ARB shall determine the amount of offset credits that corresponds to the overstatement); or

~~(3)~~(2)The offset project did not meet all local, state, or national regulatory requirements during the time covered by an Offset Project Data Report; or

~~(4)~~(3)ARB determines that Offset credits have been issued in any other voluntary or mandatory program within the same offset project boundary or for the same GHG reductions or GHG removal enhancements covered by an Offset Project Data Report.

~~(5) If an offset project is developed under Compliance Offset Protocol U.S. Ozone Depleting Substances Projects, ARB may invalidate within five years of issuance of the ARB offset credits covered by an Offset Project Data Report.~~

~~(6) If an offset project is verified after three years of ARB offset credit issuance by a different offset verifier, ARB may invalidate within five years of issuance of the ARB offset credits covered by and Offset project Data Report~~

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~~(7)~~(4)An update to a Compliance Offset Protocol in itself, will not result in an invalidation of ARB offset credits issued under a previous version of the Compliance Offset Protocol.

(c) If ARB ~~determines that an ARB offset credit is invalid~~ makes a determination pursuant to section 95985(b), ARB will:

(1) Identify all parties that may have some responsibility for the action that gave rise to the determination. Such parties may include:

~~(1)~~ (2) ~~Identify~~ The current holder of an ARB offset credit that has not been transferred to a compliance account or submitted for retirement;

~~(2)~~ (3) ~~Identify~~ The entity that holds an ARB offset credit in its compliance account or has submitted it for compliance or retirement; and

~~(3)~~ (4) The Offset Project Operator and Authorized Project Designee, and, if applicable, the Forest Owner~~, if applicable.~~

(d) ARB will notify the parties identified in section 95985(c) of the ~~invalidation~~ determination pursuant to section 95985(b) and provide ~~the~~ each party an opportunity to submit additional information to ARB ~~prior to invalidation~~ as follows:

(1) ARB will include the reason for the ~~invalidation of an ARB offset credit~~ determination pursuant to section 95985(b) in its notification to the part~~y~~ies identified in 95985(c).

(2) After notification the part~~y~~ies identified in 95985(c) will have 25 calendar days to provide any additional information to ARB.

(3) ARB may request any additional information as needed in addition to the information provided under this section.

(4) The Executive Officer will have 30 days after all information is submitted under this section to make a final determination ~~to invalidate an ARB offset credit~~ that one of the conditions listed pursuant to section 95985(b) has occurred, identify and notify the party responsible, and determine the number of offset credits affected and the compliance instruments that are required to be surrendered.

(e) Requirements for Surrender of Additional Compliance Instruments. If the Executive Officer ~~determines that an ARB offset credit is invalid~~ makes a determination pursuant to section 95985(b) and (d),

~~(1) The ARB offset credit will be invalidated and removed from any Holding or Compliance Account;~~

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~~(2) The party identified pursuant to section 95985(c) will be notified of ARB's determination of invalidation pursuant to section 95985(d)(4);~~

~~(3) The Offset Project Operator or Authorized Project Designee, or the Forest Owner, if applicable, of the offset project for which the ARB offset credits were invalidated will be notified of ARB's determination of invalidation pursuant to section 95985(d); and~~

~~(4) Any approved program for linkage pursuant to subarticle 12 will be notified of the invalidation at the time of ARB's determination pursuant to section 95985(d)(4).~~

~~(f) Requirements for Non-Sequestration Offset Projects. If an ARB offset credit is found to be invalid pursuant to sections 95985(b) and (d), the party identified in section 95985(c)(2)~~ the party identified by ARB under 95985(c) ~~must replace each ARB offset credit with a valid ARB offset credit or another approved compliance instrument~~ must surrender the specified number of valid ARB offset credits or other approved compliance instruments pursuant to subarticle 4, within ~~90 calendar days~~ six months of notification by ARB pursuant to section 95985(e). If the party identified in section 95985~~(c)(2)~~(c)(1) does not ~~replace each invalid ARB offset credit~~ surrender the specified number of compliance instruments within ~~90 calendar days~~ six months of the notice ~~of invalidation~~ pursuant to section 95985(e), ~~each outstanding ARB offset credit will constitute a violation pursuant to section 96014.~~

(1) ARB will retire the specified quantity of ARB offset credits from the Offset Buffer Account; and

(2) the party will be subject to enforcement action pursuant to section 96014; and

(3) each ARB offset credit retired from the Offset Buffer Account will constitute a violation pursuant to section 96014. ~~If the party identified in section 95985(c)(2) is no longer in business ARB will require the Offset Project Operator or Authorized Project Designee to replace each invalidated ARB offset credit and will notify the Offset Project Operator or Authorized Project Designee that they must replace them. The Offset Project Operator or Authorized Project Designee must replace each ARB offset credit with a valid ARB offset credit or another approved compliance instrument pursuant to subarticle 4, within 90 calendar days of notification by ARB pursuant to section 95985(e). If the Offset Project Operator or Authorized Project Designee does not replace each invalid ARB offset credit within 90 calendar days of notification by ARB pursuant to~~

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~~section 95985(e), each outstanding ARB offset credit will constitute a violation pursuant to section 96014.~~

~~(g) Requirements for Forest Offset Projects. If an ARB offset credit is found to be invalid pursuant to sections 95985(b) and (d) for a forest offset project, the Forest Owner must replace each ARB offset credit with a valid ARB offset credit or another approved compliance instrument pursuant to subarticle 4, within 90 calendar days of notification by ARB pursuant to section 95985(e). If the Forest Owner does not replace the invalid ARB offset credit within 90 calendar days of being notified by ARB pursuant to section 95985(e), each outstanding ARB offset credit will constitute a violation pursuant to 95985 96014.~~

~~(h)~~(f) Nothing in this section shall limit the authority of the State of California from pursuing enforcement action against any parties in violation of this article.

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Attachment A

Please see attached *Cross Coalition Letter to ARB regarding Buyer Liability* and *Cross Coalition White Paper to ARB on Buyer Liability*

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