Coalition for Emission Reduction Policy
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Comments of the Coalition for Emission Reduction Policy
On the
Public Workshop to Discuss Linking the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation to Western Climate Initiative Jurisdictions

February 17, 2012

I. Executive Summary

The Coalition for Emission Reduction Policy ("CERP") appreciates the opportunity to submit the following brief comments in response to the California Air Resources Board's ("ARB") February 3, 2012 public workshop to discuss the planned linkage of California's greenhouse gas ("GHG") emissions trading program with that of Québéc.

We understand that the linkage initiatives are still at an early stage. We expect to provide more detailed comments in response to specific ARB proposals on auctions, holding limits and other matters. For now, these comments focus on some of the implications – and uncertainties – around the linkage process as it relates to offsets.

II. About the Coalition for Emission Reduction Policy

CERP brings together leading companies from the energy, financial services, and emissions reduction project development sectors, all of whom support the goal of ensuring that California creates an environmentally rigorous and smoothly functioning offset system that can serve as a model for other cap-and-trade programs. CERP members share ARB's commitment to ensuring that offset credits only issued for projects that achieve emission reductions[1] that are additional, permanent, independently verified, enforceable, and measurable.

CERP's mission is to educate policymakers and the general public about the benefits of using offset credits from GHG emission reduction projects in uncapped sectors of the economy, and in other countries, as a means of meeting emission reduction goals. In California, CERP has offered a constructive voice in the development of ARB's cap-and-

[1] Unless otherwise specified, any references to "emission reductions" also encompass sequestration and avoided emissions.

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trade program by providing extensive comments at each stage of the proceedings that led up to the adoption of the final regulation.[2]

A list of CERP's members is provided as an Appendix to these comments.

III. A Robust Offsets Market is Critical to a Linked Cap and Trade System

As CERP has previously explained in comments to ARB, a functional offset credit system has a crucial role to play in a linked cap-and-trade system. The inclusion of offsets will broaden participation in the effort to provide climate solutions—including from farmers, forest owners, and others. The offsets program will also encourage innovation in uncapped sectors of the economy, including methane digesters and forest carbon management.

Most important, offsets form a cornerstone of ARB's strategy for containing the costs associated with the cap-and-trade program. Many uncapped sectors of the economy present opportunities for cost-effective emission reductions that, absent an offset credits system, would not be available to entities with compliance obligations. If available in adequate supply, offset credits will alleviate scarcity in the allowance market and moderate increases in the price of compliance instruments. Indeed, ARB's own analysis of the cap-and-trade regulations identifies the supply of offset credits as an important factor influencing the economic impact and costs of the overall program.[3]

IV. Issues and Uncertainties Raised by the Proposed Linkage

The important benefits of offsets can only be realized, of course, if the linked partners complete all the necessary steps required to make the offsets program operational – and with adequate lead time for project developers to make the commercial and regulatory arrangements needed to bring projects online. In this regard, CERP continues to harbor serious concerns about the current state of the California offsets program, many of which are only amplified by the impending proposal to link the California cap-and-trade program with that of Québéc. As explained below, the plan raises several uncertainties and risks for offset project developers. If not promptly and appropriately resolved, these uncertainties will delay investment in offset projects and diminish the potential of offset credits to moderate compliance costs.

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[2] *See* CERP, Comments on ARB's Proposed Cap-and-Trade Regulations (Dec. 6, 2010); CERP, Comments on the Modified Text of ARB's Proposed Cap-and-Trade Regulations (Aug. 11, 2011); CERP, Comments on ARB's Second 15-Day Rulemaking Package (Sep. 27, 2011).

[3] ARB, Initial Statement of Reasons, Appendix N: Economic Analysis at N-11, N-12 (Oct. 2010); *see also* ARB, Final Statement of Reasons at 795 (Oct. 2011) ("We believe that a limited use of offsets is necessary in the program to contain costs and incentivize reductions in uncapped sectors . . . Allowing a limited number of offsets into the program provides cost-containment benefits . . . .").

Uncertainties Regarding Offset Protocols and Adequacy of Offset Supply

One of CERP's principal concerns is the small number of approved protocols and the potential shortfalls in offset credit supply that will result. According to a recent analysis by Point Carbon, the four protocols that ARB has approved to date will yield an inadequate supply of offset credits, even after accounting for the likely introduction of early action credits and possible availability of REDD credits. Point Carbon's analysis indicates that the potential demand for offsets from entities with compliance obligations will outstrip the available supply by 9 million credits in 2014 and 27 million credits in 2015.[4] A near-to-medium shortfall in supply of offset credits thus appears likely under ARB's current policies, especially once the natural gas distribution and transportation fuel sectors are phased into the cap-and-trade program in 2015. Note that if California ultimately links its cap-and-trade program to that of Québéc, demand for California offsets will increase still further – and because Québéc has not yet promulgated offset regulations, it is not clear whether Québéc-issued offset credits will make any meaningful contribution to supply in the near to medium term.

CERP understands that ARB staff will consider approving additional offset protocols later in 2011, and notes that the Final Regulation Order directs the Executive Officer of ARB to adopt a process for review and consideration of new protocols.[5] Although CERP is encouraged by these plans, we remind ARB that expeditious action is vital in order to avert a near-to-medium term shortage of offset credits. *Offset projects take considerable time to develop after a protocol is approved, especially for projects in the agriculture and forestry sectors.*

Only after a protocol is approved can project developers proceed to locate suitable project sites, negotiate contracts with site owners, arrange financing, register the project, and verify the offsets. This process can take many months; in the Climate Action Reserve, for example, forestry projects take an average of 717 days to move from project listing to the first issuance of credits. For livestock projects, the average time between listing and first issuance is 433 days.[6] If anything these numbers *understate* the period of time necessary to bring a project to credit issuance because listing only occurs after a project actually has commenced operation.

Given this long lead time for new projects, ARB cannot afford to wait until the eleventh hour to approve new protocols if it wishes to assure a meaningful supply of offset credits in the initial years of the cap-and-trade program.

[4] Point Carbon, A forward curve for California offsets (Nov. 17, 2011).
[5] ARB, Resolution 11-32 at 12 (Oct. 20, 2011).
[6] Communications with project developers.

The Western Climate Initiative's (WCI) recently-adopted Offset Protocol Review and Recommendation Process only exacerbates the above uncertainties by casting doubt on the validity of even the four already-approved California protocols. It is not clear to the offset project developer community whether the four existing protocols must now be subjected to additional review at the WCI level before becoming operational in California and the other WCI jurisdictions. If such review is required, doubts over the timing and ultimate outcome of the process will greatly discourage development of new offset projects.

Uncertainty Regarding Québéc Offsets Program

Rather than mitigate these concerns, ARB's forthcoming linkage rulemaking only creates new uncertainties. For instance, Québéc's cap-and-trade regulations currently provide no detail regarding which offset protocols are approved or how offset credits will be regulated. Consequently, offset project developers face great uncertainty regarding issues including, but not limited to:

- What types of projects will be eligible to generate offset credits issued by the government of Québéc;
- What listing and verification procedures must be followed in order for a project to receive Québéc-issued offset credits;
- How the governments of Québéc and California will coordinate market oversight responsibilities with respect to cross-border transactions, transactions involving both California and Québéc-issued offset credits, or transactions involving counterparties from both jurisdictions; and
- Which parties will be liable if a Québéc offset project is found to have misstated its emission reductions, and what standards will be applied to determine whether such a misstatement has occurred.
- If a project earn offset credits in California, will the project developer or credit user have to clear additional hurdles before using the credits in Québéc?

CERP members are concerned that these important uncertainties will not be resolved in time for new projects to be brought to fruition during the initial year of the cap-and-trade program. Many developers and funders of offset projects are sitting on the sideline because of these uncertainties. The potential lack of a robust Québéc offsets program will only complicate the process of linking the two cap-and-trade systems, because the linkage will increase demand for the finite supply of California offset credits without contributing additional Québéc-issued offset credits to the linked trading system. In such a market environment, it may be difficult for offset credits to make a meaningful contribution to cost containment.

Another source of uncertainty is how the two jurisdictions will address Québéc's early reduction credits (ERCs). The prospect of including ERCs presents questions of standards. ERCs also present questions of supply. According to one analysis, there may be as many as 18 million tons of ERCs.

Linkage Proceeding Should Consider Recommendations of LAO Report

We took note that a recent report of the Legislative Analyst's Office (LAO) gave ARB high marks – deservedly, in our view – for the choices made by the agency and the board in designing the cap-and-trade regulations.[7]

The LAO identified only a few areas of policy design that merited reconsideration. It seems to us that the proposed linkage rulemaking presents an opportunity for such reconsideration. In particular, we encourage ARB to re-assess two issues highlighted by the LAO report: the "buyer liability" approach to invalidating offset credits, and the quantitative limit on usage of offset credits by compliance entities.

With regard to buyer liability, a key recommendation of the LAO report is that the cap-and-trade program be modified to make offset project developers or owners – not offset credit purchasers – liable for making the program whole when a project is found to have misstated its emission reductions.[8] The report notes that because of their familiarity with and control over individual offset projects, "offset producers are in a better position to manage the risks of invalidation" than offset holders or purchasers. Moreover, the LAO recognized that ARB's buyer liability approach will create potentially unmanageable regulatory risks for purchasers and users of offset credits – risks that will complicate transactions in offsets and exacerbate the price differential between offset credits and allowances.[9] LAO's concerns regarding buyer liability mirror numerous comments by CERP and others to ARB on this issue.

The report also notes that limiting the use of offset credits to 8% of an entity's compliance obligation in the current compliance period would increase compliance costs, and that the limit itself is "somewhat arbitrary."[10] LAO therefore suggests some consideration of eliminating the offsets usage limit, and relying instead on stringent offset verification standards to protect the environmental integrity of the emission cap. As indicated in our previous comments to ARB, CERP concurs with the LAO's conclusions. As ARB considers the harmonization of its own offset credit policies with Québéc's developing

[7] LAO, *Evaluating the Policy Trade-Offs in ARB's Cap-and-Trade Program* (Feb. 9, 2012).
[8] *Id.* at 3.
[9] *Id.* at 24-25.
[10] *Id.* at 29.

offsets program, CERP urges ARB to take into account the LAO's analysis and consider amending its regulations accordingly.

V. Conclusion

CERP thanks ARB for carefully considering these comments on the Public Workshop, and looks forward to providing further input as ARB proceeds with a rulemaking to link the California and Québéc cap-and-trade programs. Please contact CERP's counsel, Kyle Danish, with any inquiries regarding these comments.

Respectfully submitted,

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Appendix A

The members of the Coalition for Emission Reduction Policy participating in these comments are:

Camco International

C-Trade

Deutsche Bank

PG&E

Verdeo Sindicatum

For more information about the coalition, see www.uscerp.org.

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