BEFORE THE
AIR RESOURCES BOARD
OF THE
STATE OF CALIFORNIA

SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY COMMENT ON ARB WORKSHOP JUNE 22, 2010: UPDATE ON OFFSETS AND LINKAGE IN A CALIFORNIA CAP-AND-TRADE PROGRAM

Norman A. Pedersen, Esq.
HANNA AND MORTON LLP
444 South Flower Street, Suite 1500
Los Angeles, California 90071-2916
Telephone: (213) 430-2510
Facsimile: (213) 623-3379
E-mail: *npedersen@hanmor.com*
lmitchell@hanmor.com

Attorney for the **SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY**

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I. INTRODUCTION AND SUMMARY

The Southern California Public Power Authority ("SCPPA") [1] respectfully submits this comment on the workshop conducted by the California Air Resources Board ("ARB") on the afternoon of June 22, 2010, entitled *Update on Offsets and Linkage in a California Cap-and-Trade Program* ("Offsets Workshop"). Offsets are a key part of the proposed cap and trade program.

SCPPA will separately provide comments on the ARB workshop on cost containment options that took place on the morning of June 22, 2010. SCPPA submitted a comment on July 9, 2010, regarding the ARB workshop on offset protocols that took place on the morning of June 23, 2010.

SCPPA's chief concern is that the ARB's approach to the offsets program – both its own protocols and linkages to existing offset programs – will be so restrictive and will be finalized so late that not enough offsets will be available at the start of the cap and trade program to contain costs. The ARB should make every effort to avoid this outcome, given the key role of offsets in cost containment (a fact repeatedly confirmed in the economic analyses of the cap and trade program). High-quality offset programs currently exist, including the Climate Action Reserve ("CAR") and the Clean Development Mechanism under the Kyoto Protocol ("CDM"). These should be utilized more fully. In relation to its own offset program, the ARB should prioritize the

[1] SCPPA is a joint powers authority. The members are Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, Los Angeles Department of Water and Power, Imperial Irrigation District, Pasadena, Riverside, and Vernon. This comment is sponsored by Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, the Imperial Irrigation District, Pasadena, and Riverside.

development of offset protocols that can be developed and implemented rapidly in sectors where there is potential for considerable emission reductions at relatively low prices.

In summary, SCPPA recommends the following to help ensure the ARB's offset protocols and links to other offset programs provide ample cost-effective emission reduction options:

For ARB's own offset protocols:

- The current ARB offset supply forecasts indicate a heavy reliance on one protocol – for the destruction of ozone-depleting substances ("ODS") – to provide the needed offsets. Other protocols that are likely to result in significant numbers of offsets should be developed rapidly.
- Do not use Californian regulatory standards in setting baselines for offset projects outside California. This is inappropriate and will substantially reduce the number of viable offset projects. Use jurisdiction-specific baselines instead.
- Allow crediting periods to be renewed as long as the offset project still meets the additionality requirements. Having only one renewal period is unnecessarily short.

For links to other offset programs:

- Rather than allowing a very restricted set of Climate Reserve Tonnes ("CRTs") to be used for compliance as early action credits and later linking to some other CAR protocols, the ARB should establish a comprehensive link with CAR as soon as possible. The link should allow any CRTs to be used for compliance except those generated by projects that use a CAR protocol after the ARB has published its own version of that protocol (e.g., forestry, ODS). This link should be included in the cap and trade regulation this year.

- Linking to the other jurisdictions participating in the Western Climate Initiative ("WCI") will be useful in expanding the carbon market and making it more liquid. However, it is unlikely to provide a significant source of additional offsets or allowances for California, given that the other WCI jurisdictions will constitute a source of demand for compliance instruments at least equal to the supply.
- Linking to the CDM should be pursued rapidly, early in 2011 if it is not able to be incorporated in the cap and trade regulation in 2010. The CDM constitutes the largest, best developed, most liquid, and most scrutinized offset program in the world. It will be an invaluable source of supply, particularly in the early years of the cap and trade program when offsets from ARB protocols and from avoided deforestation ("reducing emissions from deforestation" or "RED") are unlikely to be available in any quantity.

For both ARB and non-ARB offsets:

- The ARB should provide estimates of the number of offsets that are likely to be available from all sources, including through linkages, particularly for the first compliance period of the cap and trade program, 2012-2014. If the estimated supply is not well in excess of the total number of offsets that can be used for compliance under the program rules (including any increased offset use the ARB is considering, e.g. if allowance prices rise), the ARB should consider additional sources of supply.
- Do not restrict offset projects outside California to sectors that are not covered under the California cap and trade program. For example, energy efficiency and clean energy projects in Mexico should be allowed to earn offsets.

- The offset market will be weakened if buyers have primary liability for invalid offsets and cannot rely on the integrity of verified offsets. Buffer pools and verifier liability are straightforward and effective alternatives to buyer liability.

II. ARB OFFSET PROTOCOLS

A. Additional protocols should be developed to increase offset supply.

Slide 27 of the PowerPoint presented by the ARB staff at the Offsets Workshop ("PowerPoint") lists the four offset protocols the ARB is currently developing, with projected offset supply and offset prices for each protocol. The only protocol that is forecast to deliver a substantial number of offsets is the ODS protocol. In the crucial first compliance period 2012-2014, approximately 91 percent of all ARB offsets are predicted to come from the ODS protocol. One protocol, urban forestry, is not predicted to provide any offsets. If any offsets were generated under this protocol, they are forecast to cost $100 each.

It is risky to rely so heavily on one protocol, particularly when only a few offset providers are engaged in ODS destruction projects. If the ODS protocol does not provide as many offsets as predicted, there will be a significant shortage of offsets.

SCPPA understands that the ARB staff has been instructed to proceed with the four protocols listed on slide 27, and that the staff intends to develop additional protocols in 2011 (slide 28). SCPPA encourages the staff to determine which additional protocols are likely to provide the greatest supply of offsets within a relatively brief timeframe and to publish this list of priority protocols together with an indicative timeline for developing and finalizing these protocols. These protocols should be finalized as soon as possible in 2011 to allow project developers to establish projects, generate emission reductions, and earn offsets for sale in time for the start of the cap and trade program. Having a greater number of offset protocols available will reduce the risk of an offset shortage.

B. Do not use Californian regulatory standards to set baselines for projects outside California.

ARB staff noted (in relation to slide 11) that they are considering setting baselines for all offset projects (whether in California or outside California) with reference to Californian regulatory standards. Instead of setting baselines to reflect Californian requirements, baselines should be set with reference to the regulatory/ legal requirements applying in the jurisdiction in which the offset project takes place.

1. *AB 32 does not require Californian regulatory requirements to be applied outside California.*

Slide 11 of the PowerPoint refers to section 38562(d)(2) of the Health and Safety Code, introduced by AB 32: "the reduction is in addition to any greenhouse gas emission reduction that is otherwise required by law or regulation". Additionality is an important requirement of an offset program. However, section 38562(d)(2) in no way requires Californian law or regulations to be applied outside California when determining additionality or setting baselines. Outside California, Californian laws and regulations do not require any emission reductions – only local laws have the power to do so.

2. *Applying Californian regulatory requirements outside California will substantially reduce offset volumes.*

Applying Californian regulatory requirements would be likely to substantially reduce the number of possible offset projects and the supply of offsets. The regulations applying to certain sectors in California would leave little room for any offset projects in that sector throughout North America – for example, California's regulations requiring the capture of landfill gas. This would be a significant reduction in total available offsets.

Furthermore, even if an offset project is still theoretically possible with the higher standards, it may not be economically viable. If the baseline is required to be set much higher

than local regulations would require, relatively few offsets could be generated, and the revenue from their sale is unlikely to be sufficient to cover the extra costs of the higher standards. In this case, the project would not proceed and the supply of offsets would be further diminished.

3. *Using jurisdiction-specific standards will not be a disincentive for that jurisdiction to shift towards more stringent standards.*

One reason for using Californian regulatory standards to set baselines may be the belief that doing so avoids "rewarding" jurisdictions for setting low standards and avoids the perverse incentive not to set higher standards. However, this view is not supported in practice.

Setting baselines according to local rules and practice does not remove the incentive for industries in a jurisdiction to increase their performance. If offset projects are allowed with a local baseline and many projects are implemented in a particular sector in a particular jurisdiction, over time the standards of common practice ("business as usual") change because the emission reductions activities will become common, and the baseline will become more stringent. A new project in that jurisdiction will have to show that it exceeds the new baseline in order to earn offsets. In this way standards to earn offsets become more stringent over time, independently of regulation.

On the other hand, if baselines are set using Californian standards, few offset projects may be viable, there is no guarantee that local laws will become more stringent, and local industry standards may not change.

The concern with "rewarding" countries for less stringent regulation has been raised in relation to the CDM. China and India both have large numbers of CDM projects, where offsets are issued for exceeding project-specific (i.e., local) baselines. However, this has not deterred each of those countries from enacting various emission-reduction laws and setting ambitious

national and regional targets, for example in relation to renewable energy and energy efficiency. China's success in developing its renewable energy industry is an example to many countries.

Countries, states, and provinces have many reasons for enacting (or not enacting) more stringent environmental regulations and pursuing clean-energy goals. Whether or not a jurisdiction takes these steps has little to do with whether entities in that jurisdiction can earn offsets for particular activities.

Therefore there is no reason to set baselines according to Californian rather than local regulations.

C. Allow crediting periods to be renewed as long as reductions remain additional.

Slide 12 of the PowerPoint proposes a 5-10 year crediting period for non-sequestration projects, with only one renewal period. Therefore, even if a project remains additional at the end of its first five-year crediting period, it may only be able to earn offsets for 10 years in total. This is a relatively short earning period, particularly as offset projects often require considerable upfront capital and annual revenue will fluctuate depending on the emission reductions generated and the price of offsets. Given the risks, investors may not consider this period long enough to justify investing in an offset project.

As long as a project owner can demonstrate at the end of each (renewed) crediting period that its project remains additional under current regulatory requirements and common practice, it should be allowed to keep renewing the crediting period.

III. LINKS TO OTHER OFFSET PROGRAMS

A. Establish a comprehensive link to CAR upfront.

In slide 21 of the PowerPoint, the ARB staff proposes to recognize early action by allowing entities to use for compliance with the cap and trade program CRTs issued under the

three CAR protocols the ARB had approved. Only CRTs generated using specific versions of the three CAR protocols would be allowed. All of these versions have now been superseded – improved protocols are now available.

1. *There are few eligible early action CRTs.*

The table below indicates the number of projects which have been issued CRTs, and the total number of CRTs issued and retired to date, for each of the four recognized versions of the protocols (taken from the CAR website, https://thereserve1.apx.com/myModule/rpt/myrpt.asp?r=112, on July 13, 2010):

CAR Protocol	No. of projects	CRTs issued	CRTs retired
Forestry version 2.1	3	1,654,770	392,274
Forestry version 3.0	0	0	0
Livestock version 2.0	1	3,483	0
Urban forestry version 1.0	0	0	0
Totals	4	1,658,253	392,274

It appears that just over 1.2 million CRTs are currently eligible for use as early action credits. This is not a large number, even considering the low proposed limits on offset use.

This approach to early action credits is very restrictive. Arguably it is not sufficient to satisfy the AB 32 requirement to encourage and give credit for early emission-reduction activities (HSC § 38562(b)). Further, it encourages the use of superseded project protocols.

The ARB staff also mentioned that, under a separate process, a link to other CAR protocols may be established at a later stage.

2. *A comprehensive link is preferable to restricted early action CRTs and later linking.*

Rather than allowing a restricted set of CRTs to be used for compliance as early action credits and later linking to some other CAR protocols, the ARB should establish a comprehensive link with CAR as soon as possible. CAR offset project protocols are widely respected. They were developed by experts through a public process with input from many organizations including the ARB itself, and they are based on criteria that the emission reductions be additional, real, permanent, and verifiable. There is no reason not to allow a broader use of CRTs on an ongoing basis as well as to recognize early action.

The link to the cap and trade program should allow CRTs from any version of any finalized CAR protocol to be used for compliance, with the exception of CRTs generated by projects that use a CAR protocol after the date on which the ARB has published its own version of that protocol. For example, if the ARB publishes an ARB ODS offset protocol based largely on the CAR protocol in January 2011, CRTs issued under CAR ODS protocols prior to that date would be able to be used for compliance.

The link to CAR should be included in the cap and trade regulation this year, for maximum certainty.

This approach would satisfy AB 32 requirements to recognize early action. It would also help ensure a much-needed supply of offsets early in the cap and trade program before the ARB has had time to develop many of its own protocols.

B. Linking to the WCI will provide additional demand as well as additional supply.

Slide 20 of the PowerPoint discusses linking the California cap and trade program with the cap and trade programs (and associated offset programs – slide 29) of other WCI jurisdictions.

SCPPA supports linking to the other WCI jurisdictions. It will expand the carbon market and make it more liquid. However, it is unlikely to provide a significant source of additional offsets or allowances for use in California. The other WCI jurisdictions will issue allowances based on their own capped emissions, and compliance entities in those jurisdictions will need to purchase them – overall, supply will increase, but so will demand. The other WCI jurisdictions face the same issues as California in establishing viable offset programs.

Therefore California should pursue links to other WCI jurisdictions but should not rely on those links as a source of cheap, accessible compliance instruments. Other sources of offsets will be needed for cost containment.

C. Link to the CDM before the start of the cap and trade program.

Slide 29 of the PowerPoint notes that the ARB may allow offsets from some types of CDM projects to be used for compliance. Two examples of potentially-acceptable CDM projects are given: projects in least-developed countries and projects that reduce black carbon emissions. These project types have not historically produced many offsets.

However, the CDM is not listed as a potential short-term linkage opportunity or even a medium-term linkage opportunity (slides 20-22). There is no timeframe for determining whether and what types of CDM offsets can be used.

This reluctance to link to the CDM is not justified. The CDM constitutes the largest, best developed, most liquid and most scrutinized offset program in the world, and CDM offsets are accepted as compliance instruments in regional, national and international emissions trading programs.[2] It is frequently examined and improved. It is subject to oversight and enforcement by an experienced international agency.

[2] For example, the Regional Greenhouse Gas Initiative, the New Zealand emissions trading scheme and the European Union trading scheme.

The CDM can be an invaluable source of offset supply, particularly in the early years of the cap and trade program when offsets from ARB protocols and from RED are unlikely to be available in any quantity.

Linking to the CDM should be pursued rapidly, early in 2011 if it is not able to be incorporated in the cap and trade regulation in 2010. This will provide certainty and stimulate the development of additional CDM projects. The ARB may wish to exclude certain types of CDM projects but should avoid being overly restrictive. Allowing offsets from a range of project types is important to reduce the risk that any issues with one protocol will greatly reduce the total supply of offsets.

IV. ISSUES APPLYING TO ARB AND NON-ARB OFFSETS

A. Consider buffer pools and verifier liability in place of buyer liability.

Slide 24 notes that "covered entities that surrender offsets later deemed ineligible are responsible for replacing the lost tons". This approach is often referred to as "buyer liability", though this is not quite accurate as an offset may pass through several buyers before a covered entity surrenders it.

SCPPA understands that this approach appeals to the ARB because the ARB has a direct relationship with and authority over compliance entities but may not have such a relationship with offset project developers.

1. *Buyer liability is problematic.*

The buyer liability approach is problematic and would hamper the development of a liquid offset market if it is used as the primary or sole liability mechanism.

Compliance entities are likely to buy bundles of offsets from a wide variety of projects through an intermediary. Few compliance entities would have the expertise to develop their own offset projects or to negotiate directly with offset developers. It is unrealistic to expect a covered

entity to examine each project from which its offsets originate, and it is not appropriate to impose liability on an entity with little ability to ensure the validity of the offset.

Once an emission reduction has been verified and the offset has been issued, the purchaser should be able to rely on the validity of the offset. If this is not the case, and an offset that a purchaser has bought in good faith may be cancelled at any time, even after it has been surrendered, offsets will become less fungible and the offset market less liquid. The risk profile and hence the value of an offset will differ depending on the strength of the liability provisions in the chain of contracts under which the offset is transacted. This is not an ideal outcome.

Better approaches are available; the appropriate approach may vary depending on the reason for the offset being cancelled.

2. ***Reasons for offset reversal may differ.***

An offset may be reversed or deemed ineligible for different reasons. If the offset is from a sequestration project such as forestry, the sequestered carbon may be subsequently released (for example by harvesting the trees), intentionally or unintentionally. This is not possible for non-sequestration projects.

For sequestration and non-sequestration projects, it may be discovered that the verifier was given incorrect information or made mistakes in determining the emission reductions, leading to excess offsets being issued. Different approaches to liability should be used in each of these cases.

3. ***Use buffer pools to address unavoidable reversal of sequestration offsets.***

For sequestration projects, buffer pools are the best way to address the risk of unavoidable reversals. The CAR forestry protocol provides for a buffer pool from which it will retire CRTs if an unavoidable reversal occurs, but the forest owner must surrender CRTs if the

reversal was avoidable.[3] The Voluntary Carbon Standard also has a buffer pool requirement in its forestry protocol.[4]

With a buffer pool the cost and risk are shared by all projects using the relevant protocol – so reversed offsets are replaced at least cost. Buffer pools are not difficult to administer. For ARB sequestration protocols, the ARB could establish a buffer pool, it could appoint a third party to establish one, or it could require project developers to contribute to a buffer pool of their choosing.

The ARB may also consider a buffer pool approach for long-term liability for non-sequestration projects to address the risk that the at-fault entity is no longer in existence when the offsets are found to be invalid.

4. ***Verifiers could be required to replace offsets.***

The ARB will require that all emission reductions from projects using ARB offset protocols are verified by an ARB-approved verifier (slide 17). The ARB could require an entity wishing to become an approved verifier to sign an agreement providing that it (the verifier) must replace any offsets it verifies that are later determined to be invalid (other than through unavoidable reversal of sequestration offsets).

Imposing liability on the verifier for the validity of the offsets it verifies is appropriate as the verifier is in the best position and will have the requisite experience to examine the offset project and the emission reductions it generates. This has been recognized by the CDM, which requires a verifier to provide replacement offsets if its verification reports are found to be deficient.

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[3] Forest Project Protocol version 3.1, section 7; available at http://www.climateactionreserve.org/wp-content/uploads/2009/03/FPP_V3.1_with_Errata-06-08-2010.pdf.

[4] The VCS buffer tool is available at http://v-c-s.org/docs/Tool%20for%20AFOLU%20Non-Permanence%20Risk%20Analysis%20and%20Buffer%20Determination.pdf.

5. *Do not impose double liability.*

The CDM requires verifiers to replace offsets if there are doubts as to their validity. The CAR forestry protocol requires offsets to be replaced from a buffer pool if there was an unavoidable reversal. The ARB must ensure it does not impose double liability when an offset from a linked program is found to be invalid. Most offset programs to which the ARB may link already have their own liability provisions. The ARB would not need to impose a further requirement for the covered entity to replace the invalid offsets.

B. Provide estimates of offsets available from all sources.

Slide 27 of the PowerPoint provides estimates of offset supply from four ARB protocols. This is helpful but incomplete. If the ARB is proposing to link to any external offset programs and/or accept any early action credits, it is important that it consider the expected supply from each source.

The ARB should provide estimates of the number of offsets likely to be available from all eligible sources, particularly for the first compliance period of the cap and trade program, 2012-2014. If the estimated supply is not well in excess of the total number of offsets that can be used for compliance under the program rules (including any increased offset use the ARB is considering, e.g. if allowance prices rise), the ARB should consider additional sources of supply.

C. Offset projects in sectors covered by the California cap and trade program should be allowed outside California.

ARB proposes not issuing offset credits for projects in sectors that are covered by the California cap-and-trade program ("relevant sectors" – initially, energy and industrial sectors) even if the projects are located in jurisdictions where there is no emissions cap ("uncapped jurisdictions"). Thus, offset credits would not be issued for energy efficiency or renewable

energy projects that are located in uncapped jurisdictions. It is unclear whether this restriction is also intended to apply to offsets from linked programs.

This approach is unnecessarily restrictive. Many valuable emission reduction projects can be implemented in the energy and industrial sectors of uncapped jurisdictions, and there is no good reason to disallow these projects. Outside California, offset projects in a particular sector should be allowed until that sector is covered by a cap-and-trade program effective in that jurisdiction, regardless of whether the project is in a sector covered under the California program.

1. *There are no persuasive policy reasons not to allow such projects.*

It would be inappropriate to award offsets for emission reduction projects in sectors that are subject to a cap and trade program, as the emission reductions already reduce the covered entity's liability – a double counting issue. However, the double counting argument only applies to projects in relevant sectors in California and to projects outside California where there is a separate cap-and-trade program that covers the sector of the offset project (e.g., in other WCI jurisdictions). There is no double counting if projects are in relevant sectors but are located in jurisdictions that do not impose a cap-and-trade program on those sectors. Such projects would not reduce emissions that are covered by the cap-and-trade program.

For the reasons discussed in section II.B.3 above (in relation to setting baselines using Californian regulatory standards), allowing offset projects in relevant sectors in uncapped jurisdictions is not likely to result in that jurisdiction deciding never to regulate or cap emissions in those sectors.

While leakage may be a legitimate issue for some sectors, it can be separately addressed and need not preclude offsets in relevant sectors in uncapped jurisdictions.

2. *At a minimum, allow projects in relevant sectors in developing countries.*

At a minimum, the ARB should follow the WCI Design Recommendations and allow relevant-sector offset projects that are located in developing countries such as Mexico, even if such offset projects were prohibited in the USA and Canada. Section 9.7 of the WCI Design Recommendations draws a distinction between developed and developing countries for the purposes of approving offset credits. Offset projects in relevant sectors in developing countries should not be precluded.

V. CONCLUSION

SCPPA urges the ARB to consider these comments in developing the offsets program for the California cap and trade program. SCPPA appreciates the opportunity to submit these comments to the ARB.

Respectfully submitted,

/s/ Norman A. Pedersen

Norman A. Pedersen, Esq.
HANNA AND MORTON LLP
444 South Flower Street, Suite 1500
Los Angeles, California 90071-2916
Telephone: (213) 430-2510
Facsimile: (213) 623-3379
Email: npedersen@hanmor.com
lmitchell@hanmor.com

Attorney for the **SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY**

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