



# The Role of Carbon Offsets in Climate Change Legislation

[www.carbonoffsetproviders.org](http://www.carbonoffsetproviders.org)



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## What is the Carbon Offset Providers Coalition?

The Carbon Offset Providers Coalition comprises leading companies in the carbon offset market, including those involved in financing, producing, generating, providing, aggregating and/or marketing greenhouse gas ("GHG") emission reductions for sale as offsets in existing and emerging voluntary and regulatory GHG emission trading markets. The Coalition's purpose is to ensure that evolving GHG regulatory regimes in the United States are developed in a manner that promotes both environmental integrity and economic efficiency.

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## Coalition Members

The Founding Members of the Carbon Offset Providers Coalition are the leaders in the carbon offset market. The members are operating or working with offset projects in the United States and abroad that utilize proven methodologies for reducing, avoiding and sequestering GHG emissions.

### Blue Source, LLC

[www.ghgworks.com](http://www.ghgworks.com)

### CommonWealth Resource Management Corporation

[www.crmcx.com](http://www.crmcx.com)

### Environmental Credit Corporation

[www.envcc.com](http://www.envcc.com)

### Iberdrola Renewable Energies USA

[www.communityenergy.biz](http://www.communityenergy.biz)

### MGM International

[www.mgminter.com](http://www.mgminter.com)

### Sindicatum Carbon Capital

[www.sindicatum.com/carboncapital-index.html](http://www.sindicatum.com/carboncapital-index.html)



## Executive Summary of the Coalition's Views

Climate change is an urgent problem that will require all means available to achieve the GHG emissions reductions necessary to stabilize the climate. We join the growing consensus that market-based cap-and-trade programs that include offsets offer the best way to meet the challenges of climate change and should be utilized in federal legislation.

Cap-and-trade programs harness the power of the marketplace to provide incentives for the development of new technologies as well as encouraging broad participation across the econ-

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### What are Offsets?

We use the term "offsets" to refer to uniform, tradable units of GHG emission reductions generated by entities that are not subject to GHG emission limits. We use the term "allowances" to refer to similar uniform, tradable units of GHG emissions that represent the allocated quantity of emissions that the entities that are subject to GHG emission limits under a specific regulatory regime are allowed to emit, either individually, or (for example, in the case of a so-called "cap and trade" program) as a group. Both "offsets" and "allowances" are sometimes referred to as "credits," although in an effort to avoid confusion we do not use that more general term here.

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omy. Offsets serve as a valuable tool for reducing GHG emissions in both the short and long-term and work best within a cap-and-trade program.

Offsets provide regulated entities with additional flexibility and compliance options to reduce GHG emissions using existing, proven technologies and resources, while new technologies are developed to reduce reliance on carbon-based fuels and further reduce GHG emissions.

While offsets have value in reducing GHG emissions in both the near- and long-term, they have particular value in the near-term, as they will ease the transition to the new carbon-constrained economy. No one contends that offsets alone are the answer to global warming. Rather, they are one of many valuable tools, and we will need all of the tools at hand to meet the challenges of climate change.

By achieving verifiable GHG emissions reductions now, offsets help ensure an efficient allocation of resources, thereby enabling resources to be used to help develop the new technologies that will be necessary to meet the objectives of federal legislation, as well as other basic social and economic needs of all Americans.

We believe that an offset program should be implemented as part of a federal GHG regulatory regime. The points below address:

- key design principles of a GHG regulatory regime, including the importance of a cap-and-trade program and the benefits of offsets within such a regime.
- important elements that should be incorporated into an offset program.



## TWO KEY PRINCIPLES FOR THE DESIGN OF A GHG EMISSIONS REDUCTION REGULATORY REGIME

Although the Coalition's primary focus is on the specific details of an offset program that should be established under any GHG regulatory regime, we highlight two key design principles that should be integrated into the foundation of a market-based GHG reduction regime: (1) the regulatory framework should be based on a cap-and-trade approach; and (2) the regulatory framework should include a program for the recognition of offsets from project-based GHG reductions. Our views are based largely on our members' experience participating in the existing GHG emissions trading markets.

### 1. Cap-and-Trade is the Best Model For An Economy-Wide Program

GHG emission reductions should be accomplished through a market-driven approach based on a cap-and-trade program that includes as many economic sectors as is reasonably practical and places specified limits on GHG emissions. Market trading is the only proven system that allows businesses to identify the most cost-effective means of reducing GHGs to achieve our climate goals while minimizing negative impacts on the economy and tax base. At the same time, a cap-and-trade system will provide a level playing field for regulated entities, create opportunities for the market to identify cost-effective reductions to minimize the economic impact, and set a market-driven price signal for carbon that will drive innovation for a long-term solution to the climate change problem.

### 2. Offsets Should Be Eligible for Compliance

Entities subject to GHG emissions controls should be permitted to satisfy their reduction obligations through the purchase of qualified, standardized GHG offsets. As discussed below, offsets provide numerous environmental and economic benefits and are equally effective in reducing GHGs, and in many ways are superior to, internal reductions or the purchase of allocations on the emissions market. The specific design elements that we believe will be important in developing an offset program are discussed in detail below.

*Offsets are an environmentally beneficial and cost-effective market mechanism for reducing GHG emissions*

Offsets are an environmentally beneficial and cost-effective market mechanism for capturing the environmental and economic value of the verified GHG emissions reductions created by entities that are not otherwise subject to a GHG regulatory regime. In essence, it is a market exchange unit that measures GHG emission reductions achieved by projects using a variety of means. Examples that are recognized in other GHG emissions markets include carbon sequestration, methane capture, energy efficiency, and renewable energy projects. Offsets are distinct from GHG emission allowances that are issued to and traded by regulated entities within a cap-and-trade program. Unlike allowances, offsets normally are generated by projects outside of the GHG regulatory regime which achieve GHG emission reductions beyond what would otherwise occur. Offsets that meet defined eligibility re-





quirements can be purchased by regulated entities and used to meet the emissions limits that apply to them under a GHG regulatory regime.

*Offsets provide numerous environmental and economic benefits.*

The benefits of offsets are many, but we focus on the following four. Offsets provide: (a) immediate, environmentally beneficial reductions in GHG emissions using proven methodologies; (b) flexibility in achieving emission reductions through lower cost compliance mechanisms that prevents premature retirement of assets, preserves economic competitiveness, and improves allocation of resources; (c) maximum participation of all sources of GHG emissions, including non-regulated sources, thereby increasing emissions reductions throughout the economy and reducing the overall cost of the regime; and (d) clear, direct financial incentives for innovation.

- *Offsets offer near-term, environmentally-friendly reductions in GHG emissions that are real, verifiable, and additional*

Offsets offer immediate environmental benefits by taking advantage of existing, proven technologies for reducing GHG emissions that do not require substantial investment of time or capital. Projects such as carbon sequestration, methane capture, energy efficiency, and renewable energy are proven methods of reducing GHG emissions that also provide collateral environmental benefits, including natural resources restoration, improved water quality management, reduction of other air pollut-

ants, and also economic support of forestry and farming, sectors that often have been neglected. Many offset projects offer opportunities for clean development in parts of the world that desperately need it. Further, a well-designed offset mechanism can address perceived environmental risks by ensuring that only qualified reductions in GHG emissions are used to generate offsets.

- *Offsets provide flexibility to achieve compliance through lower-cost compliance mechanisms that prevent premature retirement of assets*

Offsets offer regulated sources of GHG emissions the flexibility to achieve compliance through mechanisms that often cost less than the measures that would be necessary to reduce their own GHG emissions. A concern with any GHG reduction program is that it will force businesses to retire assets before the end of their useful lives or invest heavily in unproven technologies that may provide only marginal GHG reduction benefits. While a cap-and-trade system addresses this concern in part by allowing companies to buy and sell allocations to achieve compliance, a trading program that recognizes only reductions within the regulated community (or within a particular industry sector) still limits compliance options. For regulated entities with prohibitively expensive compliance options, assets with remaining useful life may be prematurely retired or replaced with assets that provide only marginal emission reductions. This stifles the economy and misallocates limited capital resources. Offsets address this concern by increasing the compliance tools available to regulated sources of GHG emissions and



allowing them to utilize the most efficient mechanisms to achieve compliance.

- *Offsets maximize GHG reductions by increasing participation and reducing emissions from non-regulated sources*

Unlike a command-and-control regime or a carbon tax, offsets reduce emissions from sources outside the regulated community and from sources that otherwise may be difficult to target with other abatement mechanisms, thereby maximizing reductions throughout the economy. Offsets also provide clear financial incentives to unregulated sources of GHG emissions that can reduce emissions efficiently by generating offsets that can be sold to and used by regulated sources with higher compliance costs. Similarly, offsets encourage technology developers to create low-cost compliance options. Given the global reality of climate change and its effects in the United States, reductions throughout the economy will be vital to stabilizing the climate and protecting our natural resources. Use of offsets increases the type and quantity of GHGs included within the regulatory regime and provides further incentives to reduce emissions wherever emitted.

- *Offsets stimulate innovation*

Offsets provide clear financial incentives for technological innovation over the short- and long-term. Achieving our climate goals will necessitate development of new technologies and products to reduce GHG emissions. Businesses that rely heavily on GHG emitting substances and processes will be forced to develop methodologies for monitoring, report-

ing, and controlling emissions, in addition to reducing their reliance on carbon-based energy. The businesses that are most successful at addressing carbon emissions will become more competitive. Offsets provide direct financial incentives for both regulated and non-regulated entities to reduce GHG emissions and develop technologies necessary to achieve these objectives.

#### *An offset program should be developed now*

Combating climate change will require significant technological development and capital investment. Offsets are a formidable tool for reducing emissions through already established methods of reducing GHGs. Enabling the deployment of these projects will generate necessary experience in reducing emissions while more time- and cost-intensive technologies are developed to reduce our reliance on carbon based fuels and technologies. The Coalition acknowledges that offsets are not the sole solution to reducing GHG emissions over the long-term; rather, they are an important part of the solution. Offsets are particularly important in the near-term, however, as they provide real and immediate opportunities to significantly reduce GHG emissions at comparatively low-cost, with both environmental and economic benefits.

The viability of a robust offset market will depend in large part on the expectations of investors and project developers. Uncertainty about the terms for offsets or whether they'll even be recognized will both delay and limit the ability of this market to grow and to develop new projects to help address the challenges of climate change. It thus is important



to design an integrated GHG reduction regime that takes into account at the outset the role of key elements such as offsets.

## SPECIFIC DESIGN ELEMENTS FOR AN OFFSET PROGRAM

Given the merits of offsets, we believe that it is vital that the elements of an offset program be considered now during the overall design phase of a GHG regulatory program. The points below highlight the key elements of an offset program.

### 1. A Credible, Balanced Authority Must Establish and Maintain the Qualification Standards for Offsets

As an initial matter, it is vital that the qualification standards and the rules governing the determination of project qualification, monitoring and verification should be established by a regulatory authority through an open, consensus-based, public participation process. We look forward to working with legislative and regulatory authorities as the process moves forward.

In general terms, the offset program should include a clear description of what kind of offset qualifies as equivalent to an emissions allocation unit that can be freely traded and used for compliance within the regulatory scheme. *Qualified offsets must result in GHG emission reductions that are real, verifiable and verified, transparent, and additional (as defined by an objectively measurable standard).* To be effective, it is essential that all processes must be credible and efficient, both of which also mandate that the process be transparent.

The primary challenge in designing an effective

offset program is in striking an appropriate balance between the need to ensure the environmental integrity of offsets being sold on the compliance market, and the need to ensure that those integrity-promoting measures are not structured so as to stifle the incentives for investment in new offset projects. Offset programs that are designed solely with environmental integrity in mind, without taking into account the needs of project investors for certainty and stability, will cause the program to be stillborn, as investments in this market will not occur. That would cause compliance costs for regulated entities to increase, and cost-effective opportunities to generate emission reductions outside the system will not emerge.

It is generally recognized, and it has been our members' experience, that the offset programs in existing regulatory markets have followed that unfortunate path. We believe it to be vitally important that the United States avoid these mistakes. And it can do so, for a balance that achieves environmental integrity, while minimizing the risks that have discouraged investments in other offset markets, is achievable. We here identify several elements that would contribute to such a balance.

### 2. Any Project that Meets the Standards for Qualifying Offsets Should Be Eligible for Emission Trading

A basic design principle is that any type of offset project meeting the standards for a qualified offset should be eligible. There should be no exclusive list of qualifying offset project types, nor should other offset types be excluded at the outset simply because they rely on methodologies for baselines, measurement or verification that





have not been previously approved.

A GHG regime should, however, consider the adoption of a pre-approved list of specific project activities that are recognized as additional and otherwise qualified, in order to streamline the approval process and reduce the risk to investors that a project will not be qualified. This list should serve to “fast-track” certain well-recognized project categories. It should not, however, serve to exclude the recognition and qualification of otherwise qualified projects. *Any project that meets the qualification criteria should be eligible.*

For those projects that do not fall within the pre-approved category, they should be reviewed according to an individual approval process that is transparent and timely. One model for the approval process that reduces investor risks and improves the prospects for financing project activities is a two-step process of registration and issuance. Under this model, a project can receive an advance determination of qualification, which will allow developers to raise capital and develop the project, followed by the subsequent verification of emission reductions after operations commence and implementation is confirmed. Delaying a determination about whether a particular project will qualify under the program will increase investor uncertainty and reduce the number of projects that are developed and introduced into the market. Unnecessarily stringent limitations on the types of projects that qualify as generating offsets will increase that uncertainty, and therefore should be avoided.

To be sure, different project types will bear different environmental risks. The existence of risks

must not halt action though. The challenge of global warming is too great and too immediate to afford the luxury of avoiding all risk. And there is no need to do so, as there are ways to address such risks. A well-designed offset program need not exclude projects with environmental risks *ab initio*, nor should it impose insurmountable barriers to entry for offset project developers. Instead, risks associated with a particular project, or with a particular category of projects, can and should be identified and managed through specific design elements in the offset program. These risk management tools include, for example, the adoption of conservative measurement and verification protocols for projects that pose inherent measurement challenges (*i.e.*, risk-based discounting at the offset issuance stage).

Conversely, project types that pose minimal risks and present well-established measurement and verification protocols should benefit from design elements in the program that ensure rapid eligibility review and streamlined issuance of offsets. For project activities that have well-established reduction results, for example, offsets could be issued based on a pre-approved formula rather than a case-by-case measuring and verification process. Alternatively, they could benefit from pre-approved measurement and verification protocols, rather than being required to develop and justify individually tailored protocols on a project-by-project basis.

### **3. The Standards for Additionality Should Be Practical, Environmentally Sound, and Objective**

The standard for evaluating additionality should be one that is *practical, environmentally sound,*





*and objectively measurable.* Rather than a subjective analysis of the intent of the project developer, the additionality standard should be aimed at developing an objective assessment of the project's performance metric.

There are a number of alternative regulatory approaches to confirm the additionality of projects that could satisfy this basic principle, striking the appropriate balance between environmental integrity and the certainty that investors and project developers require in order to foster a functioning market. We believe that the best way to achieve this balance is to define additionality in terms of whether or not a project is additional to regulatory mandates.

Massachusetts recently looked closely at this issue. In 2005 the Massachusetts Department of Environmental Protection ("MassDEP") proposed regulations regarding the offsets portion of its GHG reduction program. It then held numerous public hearings and received voluminous comments. As in other discussions of additionality, many of the public comments endorsed the concept of "financial additionality," suggesting that offset projects should be disqualified if economic factors other than the potential economic value of the offsets help to support the project or lead to its inception. In its Response to comments late last year, MassDEP concluded that "the concept of financial additionality is too subjective and difficult to determine on a case-by-case basis."<sup>1</sup> Accordingly, MassDEP revised its definition to clarify that the standard turns on whether an offset project is in addition to regulatory mandates.<sup>2</sup> This approach is both practical and objective, requiring only reference to existing regulations and not an entity's subjective intent. Moreover, because the standard hinges upon

regulatory mandates, it provides sufficient discretion to the regulatory authorities to ensure the environmental integrity of offset projects.

Lastly, it is important to place this discussion in its real world context. Some contend that the commercial arrangements that are the basis of a project can never change. In our experience as project developers, owners and operators that are actually creating these projects, this view does not reflect market realities. A limitation on qualifying offsets based on subjective and unnecessarily constrained requirements will stifle this emerging market in its infancy.

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<sup>1</sup> Response To Comments On Proposed Amendments To 310 CMR 7.00 *et seq.*; 310 CMR 7.00 Appendix B: "Emission Banking, Trading and Averaging"; and 310 CMR 7.29, "Emissions Standards for Power Plants" (MassDEP Bureau of Waste Prevention) (September 2006) at 7; available at [www.mass.gov/dep/air/laws/ghgrtc06.doc](http://www.mass.gov/dep/air/laws/ghgrtc06.doc).

<sup>2</sup> The final definition, *see id.* at 26, states:

**"Additional"** means GHG emission reductions, avoided emissions, or sequestered emissions that are not required by local, state, or federal law or regulation, or as part of a local, state, or federal permit, plan, or plan approval, agreement, administrative or judicial order, or as part of an enforcement action (including such laws, regulations, permits, plans, plan approvals, agreements, orders or actions taken to reduce other pollutants) at the time of submittal of a certification application. A requirement to obtain a permit or plan approval under local, state, or federal law solely for the purpose of constructing, installing, or operating a voluntary emission reduction, avoided emission, or sequestered emission project shall not be considered when determining whether or not such project is additional.



#### **4. The Geographic Scope of Qualifying Offsets Should Not Be Limited; Offsets Should Be Recognized Wherever They Are Generated**

Qualifying offsets should be recognized wherever they are generated. There is no environmental reason to favor or disfavor otherwise qualified projects solely on the basis of their geographic location, and sound economics indicates that geographic discrimination will impose unnecessary burdens on the overall cap-and-trade program. Climate change is a global problem and poses no localized “hot spot” concerns with respect to GHG emissions. Artificially imposed geographic restrictions would be inefficient from a market standpoint, and increase the cost of compliance.

Establishing a broad geographic scope for the program has economic and cultural benefits in addition to environmental benefits. It creates incentives for the development of new GHG reduction technologies by creating new markets. In addition, expanding the geographic scope can help to remove barriers to full integration in the world economy that many in rural communities both here and abroad face. Offset projects in the developing world provide invaluable opportunities to otherwise terribly disadvantaged sectors of the world’s economies and peoples, the very ones that the Stern Report amongst others have identified as those most likely to bear the greatest costs of adjustment to climate change. We invite the Committee to review the many projects in many countries including the United States, that our members have developed that not only reduce GHG emissions but also provide clean development opportunities for otherwise disadvantaged communities.

#### **5. Discounting Offsets and Quantitative Limits on Offsets Are Unnecessary**

Limits on the use of offsets to achieve compliance with GHG emission limits are not warranted. Offsets should be available for compliance purposes on a 1:1 basis with allowances (*i.e.*, not discounted *vis-a-vis* allowances), and the system should be designed so that each offset is fungible and interchangeable and can be traded efficiently as a commodity. There is no rational basis to discount the value of offsets once they are issued, since under the most widely accepted formula any qualified offset reduces the equivalent of 1 metric ton of CO<sub>2</sub> — the same measure generally used for allowances. Discounting unnecessarily hampers market efficiency and prevents businesses from using the most cost-effective means to address global warming.

The proportion of offsets that a regulated entity is permitted to use to meet its emission reduction obligations should not be excessively constrained. We believe that the type of quantitative limitations reflected in the RGGI Model Rule, for example, should not be replicated elsewhere in an economy-wide program. Establishing an adjustable quantitative limit on offset use that fluctuates based on the price of carbon, for example, would disrupt the market expectations both for investors in offset projects and for purchasers of offsets. Investors will not be able to judge the demand for their products, and purchasers will be unable to determine in advance how many offsets they can use and thus will be unwilling to make commitments to purchase them.

If we establish a fundamentally sound offset program consistent with the elements discussed



here there will be no need for any such artificial limits. Instead, the proportion of offsets that covered entities use for compliance will be constrained effectively through market forces, given that (a) the supply of offsets will be limited, and (b) the price for offsets will depend in large part on the price of emission allowances.

## **6. The Offset Market Should Be Linked to Other Markets**

The regulatory regime should be integrated as fully as is practicable with other GHG emission reduction regimes, both domestic and international. Both emission allowances and project-based offsets should be tradable among regimes to the maximum extent feasible. Climate change is a global issue. Integration into the global carbon market will reduce compliance costs.

The most critical step to ensure the viability of an offset program is the “commoditization” of the product. An offset created at point A must be completely interchangeable with an offset created at point B, and thus readily tradable on a liquid trading platform. A truly robust and liquid offset market will require a technically and economically efficient system for offset registration and trading across different compliance markets.

## **7. The Project Start Date for Offsets Should Be Established as Early as Possible.**

The project start date for offsets should be set as early in time as practicable and well in advance of the trigger date for GHG emission reductions commitments. Offset projects resulting from early actions can provide a cost-effective

means for entities to meet emission reduction targets. Offsets generated by these early projects and the transactions involving them should not be disqualified from participation in the market, provided that they otherwise meet the qualification requirements.

## **8. Changes in Regulatory Requirements Should Not Affect Established Offsets.**

If regulatory requirements change so as to affect the qualification of a particular project or project category, the offsets associated with those projects should continue to be qualified for a reasonable period of time to reflect settled expectations. We suggest that offset projects should generally be qualified for an initial period of ten years to provide assurance of value to project developers and limit delivery risk to buyers seeking to meet their emission reduction targets, in part through the use of offsets.

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## **Contact Us**

To learn more about carbon offsets, their role in a GHG regime, and the ways that the committee can tailor its advice to maximize the valuable contribution of carbon offsets, we invite you to visit our website at [www.carbonoffsetproviders.org](http://www.carbonoffsetproviders.org), or e-mail us at: [info@carbonoffsetproviders.org](mailto:info@carbonoffsetproviders.org)

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