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Comments to the California Air Resources Board Regarding Greenhouse Gas Offsets

The Division of Ratepayer Advocates (DRA) appreciates the opportunity to comment on the use of greenhouse gas (GHG) offsets in a potential cap-and-trade program under Assembly Bill 32 (AB 32). DRA is currently a party to a joint proceeding before the CPUC and California Energy Commission (CEC) that is considering issues related to regulation of GHG emissions in California.

DRA is an independent division of the California Public Utilities Commission (CPUC) that advocates on behalf of customers of public utilities within the CPUC's jurisdiction. DRA's statutory mandate is to obtain the lowest rate for service consistent with safe and reliable service. This statutory mandate is particularly important under AB 32, as the cost of GHG-reducing programs for the electricity sector will likely be borne primarily by electricity consumers. While DRA expects increases in electricity rates in order to comply with California's GHG objectives, it is DRA's duty to ensure that emissions reductions are achieved in the most cost-effective manner and that compliance costs are distributed equitably across impacted customers. Furthermore, DRA seeks to ensure that consumers receive an adequate environmental return on their investments; in other words, ratepayer expenditures spent on AB32 compliance should result in *real* reductions, rather than just reductions on paper.

DRA supports the use of offsets as they will help lower AB32 compliance costs. However, DRA also supports some restrictions on the use of offsets to ensure program integrity. In the sections that follow, DRA responds to the questions posed to stakeholders at the April 4, 2008 workshop on offsets at the ARB. Briefly, DRA recommends:

- Offsets should play an important role under AB 32 as they will allow California to achieve its GHG goals at a lower cost.
- A strong verification process is absolutely necessary to ensure the integrity of offsets. There should be periodic audits of the verification process.
- Ensuring the integrity of offsets may be difficult. Quantity limits or discounting are both ways to mitigate any shortcomings of the verification process. DRA

recommends quantity limits over discounting at this time to be more aligned with other trading programs to which California may eventually link.

- Quantification limits should not be too restrictive in order to capture the benefits of having an offsets program in the first place.
- There should not be geographic restrictions on offsets. There are likely greater opportunities for inexpensive GHG reductions outside of California and the United States.
- DRA does not recommend discounting of offsets at this time. Discounting would be a useful way to mitigate shortcomings in the verification process, and to encourage reductions within the state. However, quantitative limits and other regulatory aspects of AB 32 should be sufficient for these purposes.

1. Should California have an offsets program for compliance purposes?

Yes.

Offsets provide excellent opportunities for lowering the cost of complying with AB 32. Since it is the overall quantity of GHGs in the atmosphere that is important, the geographic location of emissions does not matter. If reductions can be made more cheaply outside of regulated sectors in California, then market participants should have the flexibility to do so.

An additional benefit of having an offsets program under AB 32 is that California's GHG policies would then be more aligned with other GHG reduction programs. The Kyoto Protocol, the Regional Greenhouse Gas Initiative (RGGI), and the proposed Climate Security Act ("Lieberman-Warner Bill") all permit the use of offsets. California may ultimately link to some of these programs, and the greater the similarities of the programs, the easier it will be to link them.

California should set an example by reducing its own GHG emissions instead of relying solely on the use of offsets to achieve its GHG emissions reductions goal. However, an offsets program will not interfere with in-state reductions. A potential cap-and-trade program will account for only a portion of GHG reductions under AB 32. Regulatory mandates such as energy efficiency and the renewable portfolio standard will likely account for the bulk of the expected emission reductions from the electricity sector.

2. What should the project approval and quantification process be for approving projects?

DRA's main recommendations for the approval process are: (a) integrity should be the most important goal; (b) ARB should take advantage of the learning curve from other offset programs; (c) ARB should require periodic audits process. The approval, quantification, verification, and monitoring processes are distinct, yet share the ultimate goal of guaranteeing integrity. Therefore, DRA's comments address all of these processes together.

a. Integrity should be the most important goal.

The integrity of offsets is of utmost importance. Clear and rigorous protocols must be developed in order to ensure additionality and permanence, and to prevent leakage. At the April 4th ARB workshop, DRA was pleased to see wide support for a strong verification process.

Often, the cost of verification is directly related to the strictness of verification protocols. DRA supports instituting an approval process that is as efficient and non-cumbersome as possible, but the integrity of the approval process must not be compromised.

b. ARB should learn from other offset programs.

DRA does not have specific recommendations at this time for the specifics of monitoring and verification protocols; however, ARB should draw on, and improve upon, the groundwork laid by the Kyoto Protocol, RGGI, and other offset systems. There is no reason to ‘reinvent the wheel,’ and some harmonization of protocols will lend to an easier integration of trading systems in the future.

DRA recognizes, however, that the protocols under these systems are not without flaws. As with any new idea, there is a learning curve on implementing the specifics. For example, recent reports have raised some concerns about the integrity of the Kyoto Protocol’s Clean Development Mechanism (CDM). Meeting the additionality requirement is often a subjective process, and can be easily manipulated if the verifying parties are not vigilant. The ARB has the advantage of learning about some of these challenges before setting their own guidelines. A few examples of these challenges are:

- Subjectivity of additionality. For projects earning revenue from offsets, it is difficult to know whether a project would have occurred anyway without the offset revenue. Without knowing for sure what *would have* occurred under different circumstances, administrators may need to rely on the word of a company or government that they would not have otherwise funded the project without offset revenue – which introduces a clear conflict of interest. The specific criteria used to determine additionality is key, as is the degree of scrutiny of the verifier. Several recent assessments concluded that a significant number of CDM projects are in fact not truly additional.¹
- Subjectivity of enforcing protocols. Determining that a project meets certain criteria can also be quite subjective. For example, predicted returns on investment are estimates, and can be easily manipulated by changing the inputs. It is important that the 3rd party verifiers scrutinize how estimates are generated,

¹ Schneider, Lambert. “Is the CDM fulfilling its environmental and sustainable development objectives? An evaluation of the CDM and options for improvement.” *Oko-Institut*, November 2007. Page 40. Available at <http://www.eko-institut.de/oekodoc/622/2007-162-en.pdf>.

rather than simply taking the word of a developer that a project is in fact additional. Periodic audits of 3rd party verifiers can assist in this goal.

- Questions regarding permanence. Even if good-faith efforts are made to guarantee the integrity of offsets, there will inevitably be risks involving the permanence of projects. For instance, a newly planted forest can be destroyed by fire. Political instability in a country could threaten the maintenance of a waste-to-energy project. Careful planning is necessary to address permanence challenges.

When establishing the specifics of the offset programs, the ARB should consult published studies and reports on the effectiveness of, and areas for improvement in, the CDM and other programs (such as the ones footnoted in this document).²

c. Undertake periodic audits of the approval process.

Evaluating the effectiveness of the verification and monitoring protocols requires review and evaluation to ensure that GHG reduction goals are being accomplished. Similarly, it would be useful to review how strictly the verifiers adhere to the protocols. The ARB should establish a periodic review process to assess the integrity of the offset program. The administrative body responsible for approving offset projects should hire an independent auditor to randomly check the integrity of approved and existing projects. This process would help the ARB assess whether established protocols are sufficient to ensure high integrity offsets, and help the ARB identify ways to improve those protocols if necessary.

² Recent reports on this issue in the EU's Clean Development mechanism include:

Michealowa, Axel and Pallav Purohit. "Additionality Determination of Indian CDM Projects: Can Indian CDM Project Developers Outwit the CDM Executive Board?" University of Zurich, February 2007. Available at <http://www.climate-strategies.org/uploads/additionality-cdm-india-cs-version9-07.pdf>.

Schneider, Lambert. "Is the CDM fulfilling its environmental and sustainable development objectives? An evaluation of the CDM and options for improvement." Oko-Institut, November 2007. Available at <http://www.oeko-institut.de/oekodoc/622/2007-162-en.pdf>.

Wara, Michael. "Measuring the Clean Development Mechanism's Performance and Potential." Stanford University, Program on Energy and Sustainable Development. July 2006. Available at http://iis-db.stanford.edu/pubs/21211/Wara_CDM.pdf.

Recent articles regarding voluntary offset markets in the US include:

"Another Inconvenient Truth," *Business Week*, 26 March 2007. Fahrenthold, David and Steven Mufson, "Cost of Saving the Climate Meets Real-World Hurdles," *The Washington Post*, 17 August 2007. "Carbon (Continued) Connoisseur," *Economist*, 13 August 2007. Revkin, Andrew, "Carbon-Neutral is Hip, but is it Green?" *The New York Times*, 29 April 2007.

3. Should there be quantitative limits on the use of offsets for compliance purposes? If so, how should the limits be determined?

Yes, quantity limits are appropriate but should not be too restrictive.

Even with strict verification protocols, integrity issues cannot be eliminated entirely, and quantity limits offer one way to mitigate the risks associated with uncertainty of real reductions. Discounting reductions from offset projects also offers a way to mitigate this risk. However, for purposes of eventually linking to other cap-and-trade programs, quantity limits are preferable to discounting.

The other major existing and proposed trading systems have set quantity limits for offsets. For example, under RGGI, offsets may comprise up to 3.3 percent of an entity's compliance obligation during a control period (if a stage one or stage two trigger occurs, this limit expands to 5 percent and 10 percent). Under the proposed Climate Security Act (the Lieberman-Warner bill), allowances may comprise up to 15 percent of an entity's obligation. None of these programs discount offsets.

The purpose of the quantity limit should be to guarantee the integrity of California's emission reduction efforts; that is, serve as a backstop in case unforeseen problems arise with offset integrity. Therefore, assuming the ARB does implement very strong verification protocols, quantity limits need not be overly strict.

A very strict limit on quantity could hamper the development of a strong market. If there are too few projects, then the market may lack the competition and experience that will ultimately drive improvements in offset projects. Additionally, the point of allowing offsets is to lower compliance costs, and if there are too few projects, their impact on overall compliance costs may be minimal.

The ARB should consider how quantity limits should change over time. Quantity limits could be stricter in the beginning as verification protocols are evaluated. Then, as verification protocols are evaluated and improved, it may be appropriate to relax the restrictions. Thus, as we gain confidence in the integrity of the offsets, we can allow a greater quantity of them. In order to facilitate more certainty in the offset market for project developers, there should be a pre-determined plan for when and how the quantity limits are expanded.

4. Should California establish geographic limits or preferences on the location of projects that could be used to generate credits within the offsets system? If so, what should be the nature of those limits or preferences?

No. Geographic locations outside of California (and the United States) may offer the strongest opportunities for inexpensive offsets. There is no reason to prevent project developers from pursuing these options.

As discussed earlier, regulatory mandates such as energy efficiency requirements, the renewable portfolio standard, and transportation-related reduction strategies will ensure that

emissions are directly reduced within California itself. Limiting offsets to California or a particular region would be unnecessarily restrictive.

5. Should California discount credits from offset projects?

DRA recognizes the advantages associated with discounting offset credits, but does not recommend doing so for California at this time.

Discounting credits could serve two purposes: (1) to mitigate potential issues with offset integrity and (2) to ‘tip the scales’ in favor of direct reductions in California. However, DRA recommends the first issue could be addressed by strict protocols and quantity limits, and the second issue would be addressed by the regulatory mandates previously discussed which will force emission reductions to take place within California.

RGGI, the CDM, and the proposed Climate Security Act do not discount credits. If California chooses to discount offset credits, it will be adding one more layer of complexity of eventually linking to one or more of these programs. Since the goals of discounting would be met through other means, DRA does not recommend discounting at this time.

Additional Issue: Fast-Tracking the Offset Protocol Process

At the April 4, 2008 workshop, several stakeholders urged ARB to quickly make decisions on allowing offset projects implemented before 2012 to count. The reasoning behind this request is that, by knowing they will receive the financial benefits of offset credits, offset project developers will have incentive to begin their projects sooner. Thus, early action would be encouraged.

DRA supports incentives for early action, but stresses that the offset eligibility and verification protocols must be fully vetted before any offset projects can be guaranteed credit. The process of establishing these protocols may take longer than project developers would like, but it is possible that they could be established before 2012. DRA supports fast-tracking the establishment of offset protocol development to the extent possible.

The ARB should be wary of the “additionality” of offset projects established before these protocols are determined. While such projects may have been pursued under the anticipation of offset revenue from AB 32 or other offset programs, the additionality of the projects would warrant close scrutiny under the ARB’s own verification protocols.

Sincerely,

/s/

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