

Comments on the Western Climate Initiative White Paper on Offset Definition and Eligibility Criteria

The Industry Provincial Offsets Group (IPOG) welcomes the opportunity to provide comment to the Partners of the Western Climate Initiative (WCI) on the recently released White Paper on Offset Definition and Eligibility Criteria. IPOG is a multi-stakeholder group with more than 20 members including four provincial governments, large industry and offset developers. IPOG members represent over 60% of industrial greenhouse gas (GHG) emissions in Canada. Our work on the development of offset protocols has also including a broader range of industry participants, including non-governmental organizations (NGOs). Over the last two years, IPOG has focused on constructive engagement on issues and governance in developing sound offsets markets.

The WCI and the State of California have been leaders in many aspects of responding to the challenge of climate change and we salute your good work. The White Paper is a further useful contribution to the emerging regulations around climate change. We would like to take this opportunity to make some general comments and then address the specific sections of the White Paper dealing with assurance that emission reductions are real, additional, permanent and verifiable.

Offsets can and should play an important role in the evolution of a market based approach to combating climate change. Not only do offsets provide an incentive for non-capped sectors to participate in reducing emissions, but they also play a key role in moderating price fluctuations in a market based system. In simple terms, prices in the carbon market are dictated by supply and demand. The demand is fixed by regulation based on the targets that are set for the covered sectors. The supply of offsets, properly designed, can provide the liquidity necessary to avoid price spikes. When operating in a market based system, regulators can lose sight of the fact that regulations create immediate demand, they don't create immediate supply. The offset system can bridge this gap and we welcome the decision of the WCI to proceed with the design of the offset system on a priority basis.

At the same time as we recognize the important contribution that a robust and liquid offset system can make to moderating prices, IPOG also realizes that the integrity of the system is fundamental. Public confidence is critical. Without it the system has no value because if the public doesn't believe that offsets convey a real environmental benefit then industry will not be granted 'permission' to use them to achieve their compliance goals and the entire system will collapse.

Real

We fully endorse the statement "Ensuring that reductions are real is critical for ensuring the integrity of the cap-and-trade program, as WCI offsets may be used in place of emission reductions in capped sectors". We would also encourage the WCI to standardize quantification protocols to avoid any requirement for adjustments between the jurisdiction where the emission reduction is created and the jurisdiction where the resulting credit may be ultimately retired. In a similar vein, we would encourage the WCI Partners to adopt standard factors for 'conservativeness' as called for in ISO 14064. The concept of calculating uncertainty on a project by project basis can place a significant burden on smaller projects which could discourage participation.

In terms of dealing with 'leakage' we fully endorse the concept that shifting an activity from inside the boundaries of a project to outside the boundaries, should not result in the

creation of credits. It is important to recognize that this issue is only relevant to a limited number of project types and can probably be most effectively addressed in the protocol and the validation of the project itself.

Additional

The White Paper states that “requiring additionality in the WCI offsets system is the desire to only credit projects that would not have otherwise occurred in the absence of an offsets mechanism”. As laudable as this objective may be, at the practical level it cannot be operationalized. Within each corporation there is always a competition for capital. There are always more projects than there are funds available so rate of return on a project is a relative not an absolute measure. An offset project doesn't only have to meet a corporate hurdle rate of return, it has to be more attractive than other available projects. Therefore, whether or not the project would ‘otherwise occur’ depends in part on the year in which it is proposed. A second complicating factor is that if the value of the credits is a critical element in project approval, the supply of the credits is forward for a period of however many years the crediting period allows and their value is unknown. As a consequence, it is impossible to do the kind of discounted cashflow analysis that is necessary to justify the investment.

Another complicating factor is that companies may undertake projects that could qualify as offsets for a range of different reasons. It may be part of a corporate branding strategy that the company is pursuing. In that case the return on their investment is going to be reflected in ‘brand equity’ and presumably product sales. On a standalone basis, the project might be a very bad investment but it could indirectly contribute significant corporate profits. This list of examples is far from exhaustive but it underlines our point that financial additionality is not just the “most controversial criteria” in the implementation of offset systems, it is impossible to operationalize in any meaningful way. Environmental additionality can be empirically calculated and verified, financial additionality cannot be.

We endorse the concept that baselines should be set in the protocols and that they should take into consideration ‘common practice’ which would not be a creditable activity. To achieve credits, a project should have to go beyond ‘common practice’. However, once the protocol has been established, the project developer must be able to depend on the rules that are defined in the protocol throughout the crediting period. At the end of the crediting period it is reasonable to do an assessment to determine whether or not ‘common practice’ has evolved in which case a project type or project may no longer be creditable. The concept that a requirement to use a technology in a specified application could retroactively disqualify a project from continuing to receive credits, even though the original crediting period has not expired, is beyond problematic.

Meaningful carbon project finance is based on the forward supply of offsets generated by the project over the entire crediting period. Carbon financiers invest in projects to obtain that future supply of credits in the expectation that they will be able to sell them at a higher price when they are issued. The possibility that the credits may never issue or stop issuing mid-crediting period due to a regulatory change would effectively kill that market. Investors deal with risk every day but it is risk that they can quantify. The risk of regulatory change is unquantifiable and would therefore prevent investors from making the investment in the first place. A “declining sunset trajectory” would have the same effect because it is an unquantifiable risk.

Permanence

We support the concept that emission reductions should be permanent because the offset credit that is created and subsequently sold will allow the emission of an equal quantity of CO₂e into the atmosphere where it will be resident from 50 to 200 years. The issue is how

to achieve permanence in bio-sequestration projects that by their nature are subject to reversal. In our view the first important concept that must be recognized is that there are two types of reversals, intentional and unintentional and they need to be treated differently. In a forest carbon management project, the operator may decide to harvest the fibre. In a soil sequestration project, the farmer may decide to rotate crops and plant potatoes which cannot be grown in untilled soil. In each case the responsible party is making a business decision based on the value of the product. If the carbon related to the earlier sequestration activity is lost as a consequence, then that becomes part of the business calculus and the responsibility for replacing it rests with the project developer.

The issue of unintentional reversals is more problematic, particularly for forest projects. At the individual forest or stand level, the risk of loss to fire, insects or disease is binary. In the case of a reversal from one of these risks, the loss is likely to be total. Across the whole of the managed forest the degree of loss would be relatively minor. The State/Provincial or National Forest Service could provide historic data by geography and species type. Given that the climate is changing and conditions may promote higher losses, the historic factor could be adjusted upwards to err on the side of conservativeness. The key point is that the regulator can hold back a reserve from credits issued for sequestration projects that can then be used subsequently to replace any credits lost through unintentional reversals. It acts as a form of insurance, with the reserve or "hold back" being the equivalent of the premium. The reserve can be monitored over time and adjusted as necessary to ensure that it maintains a positive balance.

If the obligation to replace tonnes lost--either intentionally or unintentionally-- is clearly established then there is no need to attach long-term liability and "hold subsequent landowners liable for the conditions of the legal obligation". This concept of attaching the equivalent of a lien against the land will materially affect the value of what is in most cases the project developers greatest asset and it will act as a massive disincentive to participation in the program.

Bio-sequestration projects are important to the functioning of a robust and liquid offsets system. They are sources of significant volumes and the capital cost associated with these project types tends to be lower in cost so they can play a significant role in moderating the cost of compliance. It is very important in the design of the offset system to avoid regulations that will put in place significant barriers to participation without enhancing either the integrity of the system or the environmental benefit.

Verifiable

We strongly endorse the concept, "to establish a high level of trust in the program and address public concerns related to the quality of offset projects, every effort to provide transparency in the offset system should be pursued". We believe that the use of third party verifiers is a necessary part of a credible offsets system. This is not a function that government is well suited to provide. It is also important to keep in mind that there is reputational risk for large companies and they will be vigilant in assuring the validity of the credits they acquire. For publicly traded companies, carbon transactions will be part of their financial performance and as a result will be subject to audit. That oversight will further contribute to the integrity of the offsets system.

On the issue of validation, at the project level we believe that it should be at the discretion of the project developer. If a project is using a popular technology that has been used on numerous occasions in the past, then validation is probably unnecessary and would be a financial burden on the project. In the instance where the project type is new or unique, then the project developer would be prudent to have the project validated prior to

implementation. The issue is the decision that the project developer needs to make on how to manage the risk to ensure to the extent possible that credits are issued for the project once implemented.

On the issue of enforcement, we are concerned with the reference in the White Paper that “the offset projects must be enforceable by the individual WCI partner jurisdiction that is issuing the credit and the credit must be verifiable by the individual WCI Partner jurisdiction that is accepting it.” To have a functioning market-based system, the WCI Partners need to be willing to accept that credits created in one jurisdiction will be fungible or eligible for compliance in a different Partner jurisdiction. This might be most easily achieved if there was a central authority with representatives from each Partner responsible for the offsets program administration. In any event, verification in both the issuing and cancelling jurisdictions will act as a significant deterrent to project development.

Concluding Comments

IPOG wishes to thank the WCI Partners for the opportunity to comment on this White Paper. We found the analysis, in terms of the range of offset systems that were reviewed, to be very helpful. The IPOG member companies and governments have been engaged with the carbon markets for several years. We strongly support transparency and the need to build public confidence in the system. At the same time, we have extensive experience in dealing in other, primarily commodity markets and we understand the elements that are critical to the efficient functioning of markets. We believe that it is important not to lose sight of the fact that the reason for using market-based mechanisms to achieve environmental goals is that they can do it in an economically efficient manner. To do this, markets need a clear and consistent set of rules that are not subject to wide interpretation or unanticipated change. The strength of business is the ability to adapt and to innovate. Carbon markets have the potential to stimulate unprecedented growth in technology development and deployment. We look forward to being part of that process.

We hope that you have found our comments to be constructive and we would be pleased to answer any questions that you might have.