

INDUSTRY PROVINCIAL OFFSET GROUP (IPOG)

WORKING GROUP on
OFFSET RULES & ELIGIBILITY CRITERIA

REPORT TO ENVIRONMENT CANADA

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TABLE OF CONTENTS

| | |
|-----------------------------------------------------------------------|-----------|
| Introduction | 3 |
| Environmental Integrity and Incrementality | 4 |
| Carbon Removals or Reductions | 4 |
| Minimizing Environmental and Socio-Economic Impacts | 4 |
| Incrementality | 4 |
| Definition of Eligible Sectors | 6 |
| Issue | 6 |
| Underlying Considerations | 6 |
| Primary Design Criteria | 6 |
| Other Design Criteria to Maximize Project Development and Supply..... | 7 |
| International Considerations | 7 |
| BAU and Baselines | 8 |
| Issue | 8 |
| Considerations..... | 8 |
| Key Design Parameters – Business as Usual (BAU)..... | 8 |
| Design Parameters – Clean Fuel Standard..... | 9 |
| Transaction Costs | 10 |
| Issue | 10 |
| Analysis..... | 10 |
| Recommendation | 11 |
| Annex 1 | 12 |

Introduction

The following represents the view of Canada's *Industry Provincial Offsets Group (IPOG)*, a group of representatives from provincial governments, industry and service providers. IPOG's goal is to provide the federal government with technical input and recommendations on the design and development of a robust, efficient domestic greenhouse gas (GHG) offsets system in Canada. As with previous submissions, the views and recommendations throughout this piece are supported by more than fifty organizations engaged in the nationwide IPOG process.

Prepared by members of IPOG's *Working Group on Offset Rules & Eligibility Criteria*, this report acts as a high-level checklist on key offset system rules and eligibility criteria, in order to help Environment Canada design an effective and fully-functional domestic offset system. As outlined in the Working Group's terms of reference, submitted to Environment Canada in September 2007, our main task is to develop a "technical document on options/analysis discussing criteria to establish what should be included in Canada's offset system"¹. From here, the group chose to explore four overarching issues related to system rules and design:

1. Environmental Integrity;
2. Definition of Eligible Sectors;
3. Identification of Business as Usual (BAU) and Baselines; and
4. Transaction Costs.

¹ Terms of Reference electronically submitted to Judith Hull and Lisa Minotti on September 14, 2007.

Environmental Integrity and Incrementality

Carbon Removals or Reductions²

Projects that qualify for offsets must be quantifiable, verifiable, real, unique, show clear ownership, and surplus. Having satisfied these a project can be seen as having shown real reductions or removals.

1. *Quantifiable*: Must be measurable using recognized protocols or methodologies.
2. *Verifiable*: Qualified, accredited third parties must be able to verify that the reductions or removals have been achieved as claimed.
3. *Real*: Must be a specific and identifiable action that results in emission reductions and removals (and does not simply result in emissions moving to another site or source).
4. *Unique*: A reduction or removal can be used only once to create an offset credit in the Offset System.
5. *Ownership*: There must be clear legal ownership of the reductions or removals achieved from a project.
6. *Surplus*: Reductions or removals have not occurred as the result of a specified federal greenhouse gas regulation.

Minimizing Environmental and Socio-Economic Impacts

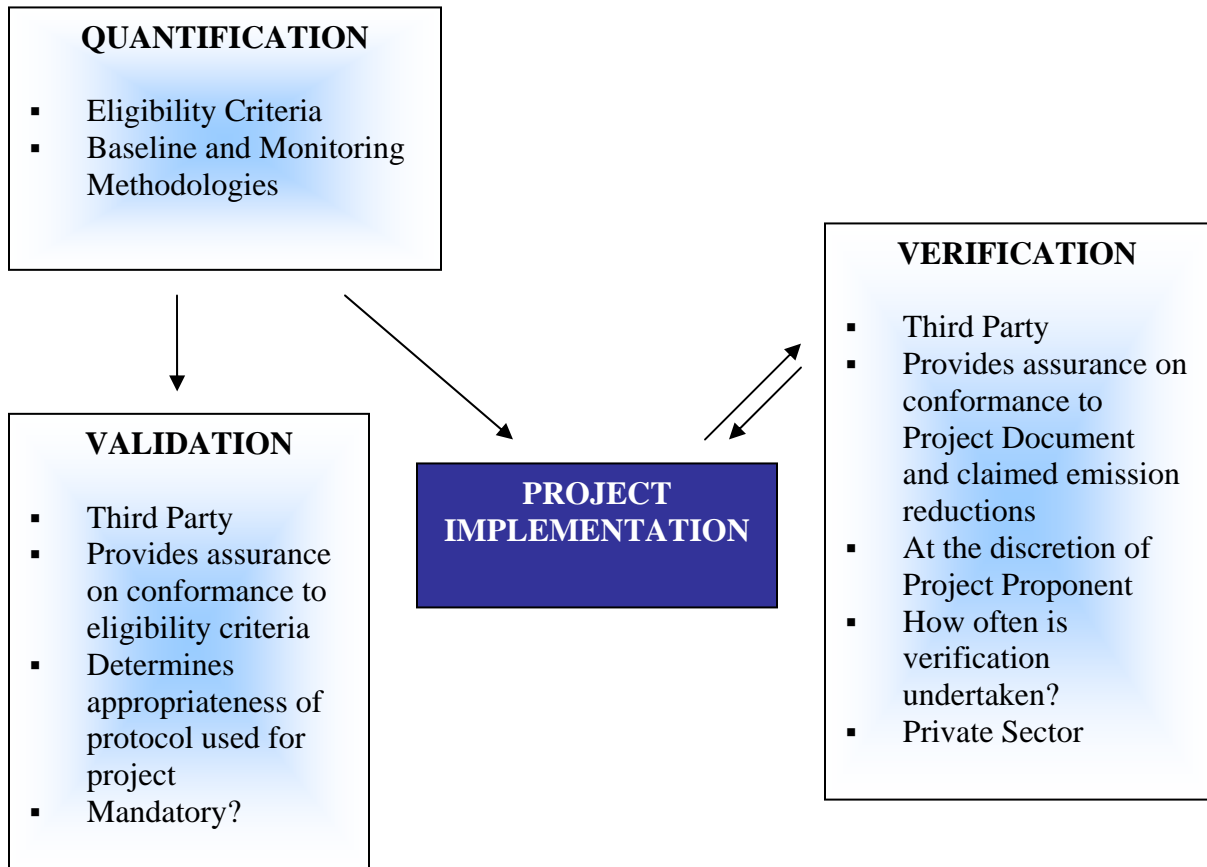
Minimizing environmental and socio-economic impacts is a key element in maintaining environmental integrity. The project must comply with current regulatory process in provincial and federal jurisdictions to address potential adverse environmental and socio-economic impacts that may arise from the implementation of a removal or reduction project. Issues such as leakage and permanence should be also addressed in these regulatory processes.

Incrementality

Incrementality can be defined as an emission reduction or removal that occurs from an action that is quantifiable, verifiable, real, unique, and surplus. The key element for incrementality should be tested on its “environmental incrementality”. Any project that has shown environmental integrity in its reductions or removals should be considered incremental.

² “Offset System for Greenhouse Gases, 2005”, Environment Canada Draft Report

Elements of Quantification and Verification³



³ From Figure 2: IPOG Final Report to Environment Canada, February 2007

Definition of Eligible Sectors

Issue

All parties in Canada's domestic offset system require a clear eligibility definition of which economic sectors can participate in the creation of offset projects.

Underlying Considerations

IPOG members hold a concern that there is a high likelihood of an offsets supply shortfall, particularly in the early years beginning in 2010. This is grounded in several observations:

- At current pace of development, Canada's domestic offset system is unlikely to be operational before 2009. There will be insufficient time before compliance requirements start in 2010 for buyers and sellers to create a robust supply/demand dynamic.
- There is minimal Canadian experience in offset transactions amongst both domestic buyers and sellers. This will further lag market development.
- Other comparative offsets systems – CDM and the emerging Alberta system – have both demonstrated supply shortfalls in their early years.

Because of arbitrary restrictions on emitting companies regarding the alternative compliance instruments of the Technology Fund and international CER instruments, there will be a strong demand for domestic offsets immediately in 2010, and yet a high probability of restricted supply.

Primary Design Criteria

Given the above, IPOG considers that the domestic offset system must be as broad and inclusive as possible to enable adequate supply creation. This translates into the following design principle:

All Canadian sectors that are not subject to GHG emission reduction targets under the federal clean air program should be eligible to create offsets.

Further, the Government may also define as eligible portions of sectors that do have emission reduction targets, but for other reasons are considered to be part of the domestic offset system. An example would be renewable power generation.

These criteria are consistent with the Government's stated offset system principle of "Maximum Scope", which states "the offset system should, to the extent practical, promote projects in all sectors and of all types".

Other Design Criteria to Maximize Project Development and Supply

1. Relevant projects should be eligible regardless of whether their sector's emissions are covered in the Canadian GHG inventory.
2. Relevant projects should not be deemed ineligible, or be discounted, by virtue of receiving funding or incentives from other federal sources.
3. Relevant projects should not be deemed ineligible by virtue of federal regulatory requirements to reduce emissions or change practice, if those regulations were not in place at the start date for eligible projects; nor should they be deemed ineligible by virtue of provincial or municipal requirements. IPOG believes the eligible start date should be Jan 1, 2000.
4. Included in the scope of relevant projects should be consideration for indirect impacts – both upstream and downstream effects, even if those are created in sectors with reduction targets under the federal clean air plan. This aspect may be subject to review after a period of time and once adequate market supply has been demonstrated.

International Considerations

1. CER and ERU instruments as part of the Kyoto mechanisms should be considered eligible instruments within the Canadian system. Their use for compliance should not be constrained.
2. Canadian domestic projects should be considered eligible, if they would have been considered eligible under the CDM and JI mechanisms.

BAU and Baselines

Issue

Regulated entities will create Internal Compliance Units (ICUs⁴) when their annual emission level is below either:

- a) For existing facilities → their target emissions intensity * annual production. [where target emission intensity = baseline emission intensity * (1-reduction requirement %)]; or
- b) For new facilities → their clean fuel standard * annual production.

Offset credits created in this manner will be automatic, based solely on reporting, and subject to random audits.

Considerations

- Such offset credits would not be subject to the requirements for project-based offsets under Canada's domestic offset system.
- These credits would be indistinguishable from offset instruments created by non-regulated sectors.
- These credits would not be limited in any manner, including:
 - Vintage date
 - Restricted volumes
 - Users ability to sell or buy from other parties
- These credits will be granted in a timely and effective manner, such that they will be available to the crediting entity for compliance use in the compliance year they were created. It is essential for credits to be approved in time for use during the annual true-up period.

Key Design Parameters – Business as Usual (BAU)

- In the context of offset credits created by regulated entities, there is no significance to “business as usual”. Baselines are established and reduction targets are applied, under which credits are created.
- In the context of non-regulated entities, there should be no subjective interpretation of “common practice”. If operations were in compliance with all relevant regulations at the time of implementing the reduction projects, then that original level of performance should be considered as the business as usual basis, regardless of practices of others in the same sector. For instance, consider a combustion facility that replaces an old boiler with a new model. Here, the creditable emission reduction would be the difference between the new boiler

⁴ ICUs are fully fungible with all other credit types.

standard and the new emission rate, rather than the difference between the old boiler's emission rate and the new boiler's emission rate⁵.

Design Parameters – Clean Fuel Standard

- For new facilities, a clean fuel standard should be established that represents the emissions performance of the best suite of technologies currently commercially available and competitive.
- The tests for:
 - *Availability* – should include confirmation that industrial suppliers have built and operated at least one other similar unit, and are prepared to build again.
 - *Competitiveness* – should be a clear indication that the level capital and operating costs of the technology should be no more than 5% greater than the preceding generation of technology, all other things being equal.
- The Clean Fuel Standard should be adjusted every 5 years following 2010 to track technological improvements. Adjustments will be made through the advice of a joint government-industry working group in each regulated sector.

⁵ In Ontario's NO_x and SO₂ market, some credit applicants have been disadvantaged by this approach, due to its affect on program economics. The key to avoiding this outcome – assuming decision-makers want to avoid this outcome – lies in the specific working of the *surplus rule*.

Transaction Costs

Issue

How to handle transaction costs within an Offset System.

Analysis

Environment Canada has stated in various forums⁶ that they are basing the Offset System on a cost-recovery basis. To impose external user fees onto participants of the Offset System, Environment Canada must follow the User Fee Act. The Act follows a four-phase approach, outlined in a flow chart in **Annex 1**, which requires an extensive and possibly lengthy public consultation process.⁷

User fees can represent a significant barrier to potential carbon abatement projects. The significant fees charged under the Clean Development Mechanism (CDM) have arguably had that effect, resulting in an advantage for projects sponsored by multinational organizations. We recommend the approach adopted by Ontario's SO₂ System and Alberta's Offset Program, where no registration, application, or other fees are charged to parties submitting a potential project for assessment. Under the Ontario and Alberta systems, the costs of the approval agency are controlled by requiring applicants to use recognized private sector protocol developers when submitting innovative proposals and requiring annual third party verification.

The Offset System is being developed to create an incentive for reducing emissions outside the regulated system. Offset credits are an additional compliance mechanism for use by regulated entities. Participation in the Offset System is taken voluntarily, yet user fees have not been discussed for surplus credits, which are emission reductions by regulated entities. Additionally, the monitoring and reporting system does not impose user fees. Both of these mandatory requirements have caused an increase in administration costs for Environment Canada.

The Offset System is being positioned to launch prior to 2010 when the regulation will impose GHG targets on specific sectors. This early implementation phase, prior to the first review period of 2012, will be a time of great uncertainty and increased risk for project proponents. After the review period (2012) the system will be more certain, and thus be able to apply lessons learned to the design of the system.

Under the proposed Offset Design (2005) the three main transaction fees included:

- Application fee: When Project Documents are submitted to the Program Authority
 - Pay more than once, if the Project Documents are found deficient

⁶ Cross-Sectoral Consultations (Montreal, May 2007), IPOG Meeting with Environment Canada (Ottawa, June 2007), and Quantification Expert Meeting (Gatineau, September 2007)

⁷ Further information on User Fee Act. http://www.tbs-sct.gc.ca/fin/euf-fue/fees_e.asp

Offset Rules & Eligibility Criteria Working Group

- Reduce cost of application if a pre-approved quantification protocol is used
- Validation fee: Paid once in queue
- Certification fee: R/R Report and Verification Report is submitted

The development of an offset project includes additional costs outside the Offset System, discussed above. These additional costs determine if a project is commercially feasible. Costs include, but are not limited to, the following:

- Project development and implementation
- Contract negotiations for technology/material for the project
- Annual costs of running the project including staffing
- Project documentation which is either developed internally or contracted to the private sector if the project proponent does not use an approved framework, or develop their own from the available approved protocol framework
- Validation by an independent third-party for the protocol and the project
- Monitoring of the project subject to the protocol requirements
- Annual verification by an independent third-party
- Trade negotiations to buy/sell credits

Recommendation

It is recommended that user fees be suspended during the implementation phase, prior to the 5 year review in 2012, of the Offset System. This early phase will be a learning process for both public and private participants and any additional user fees will result in reduced participation within the Offset System. Further, other mandatory and voluntary systems do not impose user fees and we do not see the need for them prior to the 5 year review. It is recommended that costs be addressed in the 2012 automatic 5 year review of the Offset System.

Annex 1

User Fee Proposal Approval Process
 As under the *User Fees Act (UFA)* (August 23, 2004)

