

Comments on Flexibility Mechanisms

February 10th, 2012 – *Developed and endorsed by: ENE (Environment Northeast), Conservation Law Foundation, Environmental Defense Fund, Environmental Advocates of New York, Natural Resources Defense Council, and New York Public Interest Research Group.*

The undersigned organizations welcome the opportunity to submit initial comments on flexibility mechanisms in the Regional Greenhouse Gas Initiative (RGGI), and we look forward to continuing engagement as states consider revising RGGI's offset program and potentially creating a cost containment allowance reserve.

As states consider refinements to RGGI, credit is due for the program's accomplishments to date. States have created a fair, transparent and economically beneficial system for reducing emissions of carbon dioxide (CO₂) from power plants in the region. RGGI has an impressive track record of successful allowance auctions and has to date raised over \$952 million for clean energy and other programs at the state level. These investments generate over \$1.6 billion in net economic benefits for participating states.¹ Emissions have also declined significantly since RGGI was formulated, falling approximately 34% below the emissions limit in 2011.² This decline in emissions is a positive development, and the endurance of long-lasting changes in the regional electric market³ indicates that emissions will remain down in the foreseeable future. In effect, the market trend demonstrates that emissions reductions are occurring in greater magnitude and more cost-effectively than assumed when the program was designed.

As part of the ongoing program review, states must realign the emissions budget to current market conditions⁴ in order to align the program with emission reduction objectives. In addition, updating the emissions budget from the present inflated level will alleviate the current surplus of allowances; a necessary step for any flexibility or offset mechanism to have programmatic relevance. In practice, realigning the emissions budget to market conditions is a condition precedent to the need for implementation of any flexibility mechanism. As such, these comments are provided based on the presumption that the states will implement necessary reductions to the region-wide emissions budget as part of the ongoing program evaluation so that further development of flexibility mechanisms becomes a relevant program attribute.

Flexibility mechanisms are intended to moderate price volatility, and reduced volatility enables states to set more ambitious reduction goals and achieve greater environmental and economic benefits. In order to facilitate significant adjustment of the emissions limit, we support moderate expansion of the RGGI offset program categories and creation of a well-designed cost containment allowance reserve.

Offsets

Increasing the availability of offsets is worthwhile to the degree it enable states to update RGGI's emissions limit, but any new offset types must conform to environmental integrity standards equivalent

¹ See November 2011 report by the Analysis Group, *The Economic Impacts of the Regional Greenhouse Gas Initiative on Ten Northeast and Mid-Atlantic States*, available at: <http://www.analysisgroup.com/RGGI.aspx>

² See January 2012 *RGGI Emissions Trends Report* by ENE (Environment Northeast), available at: http://www.env-ne.org/public/resources/pdf/ENE_RGGI_Emissions_Report_120110_Final.pdf

³ A 2010 New York State analysis of the decline in emissions from 2005 to 2009 found the decline predominantly due to structural changes in the regional electric sector such as fuel switching to cheaper natural gas, increasing non-emitting generation, and successful efficiency programs, see: http://www.rggi.org/docs/Retrospective_Analysis_Draft_White_Paper.pdf. ENE's recent analysis confirms that these factors continue to constrain emissions in the region and show no sign of reversing.

⁴ States should reset the emissions budget at actual 2009 emissions levels of 123.7 million tons in order to account for the evolving market conditions and meet the objective of reducing emissions from 2009 levels.

to those required in RGGI's offset protocols.⁵ Specifically, any offsets used for compliance with RGGI must be real, surplus (additional), verifiable, permanent, and enforceable. At this time the only offset protocols potentially consistent with RGGI's environmental standards are compliance offset protocols from the Climate Action Reserve (CAR) approved by the California Air Resources Board (ARB) for use in California's mandatory market-based climate program. The four offset protocols approved by ARB to date recognize:

- 1) *Livestock Projects* – capturing and destroying methane from manure management systems
- 2) *Ozone Depleting Substances Projects* – destruction of banks of ozone depleting substances within the United States
- 3) *Urban Forest Projects* – removal and sequestration of atmospheric CO₂ by urban forestry projects, and
- 4) *U.S. Forest Projects* – removal and sequestration of atmospheric CO₂ by forestry projects in the United States, including afforestation, which is currently eligible under RGGI, as well as forest management and avoided conversion, which are not.⁶

These project types have been determined to meet high environmental integrity standards similar to those required of RGGI offsets. As described by ARB's Rajinder Sahota at the January 24th, 2012 flexibility mechanisms learning session,⁷ compliance offsets recognized by ARB must be:

- Real – only actual reductions are credited, using conservative quantification methods
- Quantifiable – claimed reductions in emissions must be based on measurable, accurate calculations, using the best science to monitor and calculate reductions
- Verifiable – emissions reduction must be verified through a documented and transparent process, with requirements for document retention related to monitoring and calculations, and project site visits
- Permanent – reductions must be non-reversible, or rely on mechanisms to ensure 100 year sequestration
- Additional – credit only awarded for actions that are beyond regulation or what would otherwise occur, as determined by performance standards that account for regulatory activities that achieve GHG reductions and a review of common practice in the region
- Enforceable – reductions must be legally enforceable, establishing accountability for each step through attestations, with developers and verifiers required to submit to California jurisdiction and financial penalties on developers, and requirements for replacement of voided offsets by end users.

If RGGI states consider recognizing ARB-approved compliance offsets for use in the RGGI program, each protocol should be evaluated independently to determine consistency with RGGI standards, rather than recognizing all current and future ARB protocols. Utilizing the already developed ARB protocols

⁵ We encourage RGGI to build on prior work with California and other states and provinces in the 2010 white paper: *Ensuring Offset Quality: Design and Implementation Criteria for a High-Quality Offset Program*, see: http://rggi.org/docs/3_Regions_Offsets_Announcement_05_17_10.pdf.

⁶ For information on CA's offset program including protocols for these project types, see: <http://www.arb.ca.gov/cc/capandtrade/offsets/offsets.htm>

⁷ See: http://rggi.org/docs/ProgramReview/LearningSession2/Sahota_120124.pdf, with additional information on CA's offset program available at: <http://www.arb.ca.gov/cc/capandtrade/offsets/offsets.htm>

could expand available offset supply in the RGGI program through an expedited process. However, when considering the viability of incorporating ARB offsets, it is also important to evaluate states' enforcement obligations and capacity. As presently designed, ARB-approved offsets are enforced using California law, regardless of the location of the offset project. RGGI's offset mechanism relies on memoranda of understanding between states hosting the offset project and RGGI states, requiring the host state to support and enforce verification, including through audits, site visits, and reporting of violations. It may be possible to utilize this framework with California, but states need to explore legal implications and potential funding requirements. Additionally, if California links its program with Canadian provinces – as currently planned – this may raise additional legal considerations. We support the concept of linking RGGI with similar market-based programs in other states and provinces, and encourage states to investigate legal issues related to enforcement and fungibility of compliance instruments between programs.

We do not support changes to the quantity limit on offsets for each regulated entity and envision that the inclusion of a cost containment allowance reserve would replace the current offset trigger mechanism, which allows for increased quantities of offsets into the system.

Cost Containment Allowance Reserve

A cost containment allowance reserve that is well designed and properly implemented can make RGGI stronger by constraining price volatility, enhancing market clarity, and thus allowing states to increase stringency. As is the case with expanding offset sources, creation of a cost-containment reserve would support the necessary adjustment of the emissions limit to measured 2009 levels. Adjusting the emissions limit is needed to help match allowance supply to allowance demand and create a more effective RGGI allowance market. A well-designed reserve would enhance the predictability and functionality of the allowance market by keeping allowance prices within an optimal range. A well-designed reserve would also encourage the development of offsets and new low-carbon technologies by providing more price and market certainty.

As states evaluate the viability of a price containment reserve, we recommend consideration of a number of potential designs, with modeling of design criteria to optimize effectiveness. Instructive precedent is available from modeling of California's price control reserve,⁸ and we recommend RGGI states utilize a similar approach.

In order to build on precedent and facilitate linkage, we recommend that states consider design criteria for the price containment reserve endorsed by California and Quebec as part of the Western Climate Initiative (WCI). The WCI reserve contains a limited number of allowances (a "soft collar"), which is imperative to ensure the environmental integrity of the program. Only compliance entities may purchase allowances from the reserve, at prices well above expected market prices (the three tiers of reserve prices start at \$40, \$45, and \$50/ton in 2013, increasing annually by 5% plus the rate of inflation). States must also set a lower price boundary for allowances in order to provide continuing incentive to reduce emissions and to avoid under-valuing the public resource of allowances (which confer the right to dispose of pollution in a shared space: the atmosphere). Within the WCI the lower boundary starts at \$10/ton, increasing annually at 5% plus inflation.

A price containment reserve does not need to be large to be effective. As described by Professor Brian Murphy at the January 24th learning session, a small supply of allowances is sufficient to meet

⁸ See *Performance of a Strategic Allowance Reserve in a Cap-and-Trade Program: A Probabilistic Analysis*, Golub and Keohane, 2011, available at: <http://www.webmeets.com/AERE/2011/prog/viewpaper.asp?pid=265> [conferring with EDF to determine if this is the most appropriate reference]

incremental increases in allowance demand and suppress price increases, with a reserve of 1%-3% of the cumulative emissions limit sufficient to protect against price risk.⁹

When designing the reserve, states should pursue a design that works well under long-term imbalance circumstances such as we have been experiencing the first 3 years of RGGI. We refer here to major economic trends that can last for several years and which can reinforce rather than cancel each other out, such as relatively high or low gas prices, a relatively strong or weak economy, and especially warm or cold weather for multi-year periods. Much of the discussion of safety valves and allowance reserve programs has been discussed in terms of controlling short-term market vacillations, but longer-term, multi-year imbalance of “market fundamentals” should be considered as well.

If states establish an effective and environmentally robust cost-containment reserve, we recommend that it replace RGGI’s present offset price trigger mechanism. Market rules should be harmonized across states to the greatest degree possible, and environmental integrity would be improved by substituting a finite reserve for the current price-based offset triggers.

Additionally, as states consider incorporation of forest carbon offsets into RGGI, we encourage states to revisit biomass harvesting standards in order to reflect the evolving scientific understanding of biomass carbon neutrality.

Thank you for your attention to these comments, and we look forward to continuing engagement on this issue in the future.

⁹ See http://rggi.org/docs/ProgramReview/LearningSession2/Murray_120124.pdf