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IETA COMMENTS ON FLEXIBILITY MECHANISMS IN THE RGGI CAP-AND-TRADE PROGRAM

On behalf of the International Emissions Trading Association (IETA), I am grateful for this opportunity to provide comments on the stakeholder input regarding flexibility mechanisms, as part of the Regional Greenhouse Gas Initiative (RGGI) 2012 program review. The RGGI program has the opportunity to drive significant emissions reductions at the lowest cost to the respective economies, and IETA welcomes the chance to provide our insight on how to improve the program during this period.

IETA is dedicated to the establishment of market-based trading systems for greenhouse gas emissions that are demonstrably fair, open, efficient, accountable, and consistent across national boundaries. IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our member companies include some of North America's, and the world's, largest industrial and financial corporations—including global leaders in oil, electricity, cement, aluminum, chemicals, paper, and banking; as well as leading firms in the data verification and certification, brokering and trading, offset project development, legal, and consulting industries.

Flexibility is a key component of a successful market. By allowing alternative products to increase supply into the market, the overall impact will be to put downward pressure on costs. Within the carbon market, this flexibility is ideally provided by offsets. Offsets provide potentially lower-cost emissions reductions, compared to abatement at the source of a covered entity. This also provides liquidity to the carbon market, increasing the opportunities available to fulfill a compliance obligation. RGGI already accepts offsets as a tool for increasing compliance flexibility and bringing economic and environmental benefits for project sponsors.¹ IETA agrees with this, and we argue furthermore that enabling an environmental target to be achieved at a reduced cost benefits everyone, and in particular ratepayers across RGGI participant states.

As RGGI examines the success of flexible mechanisms in the program, and addresses the challenges of expanding their effectiveness, IETA offers some key observations and recommendations for consideration.

¹ RGGI Offsets Fact Sheet (2008), www.rggi.org



WHY ARE OFFSETS NOT CURRENTLY IN USE IN THE RGGI PROGRAM?

A cap-and-trade program is intended to achieve a defined environmental goal. RGGI has achieved its emissions reduction targets for the capped power sector during the first control period between 2009 and 2011.

Offsets provide greater opportunities for emissions reductions to be achieved from outside the capped sectors, as compared to relying solely upon abatement by capped entities. However, currently, RGGI has been able to achieve its emissions reductions within the power sector at a cost lower than abatement from alternative sectors. According to *State of the Voluntary Carbon Market 2011*, voluntary offset credit prices in 2010 averaged \$6/ton CO₂ reduced². 2012 allowances in RGGI, which indicate the marginal cost of abatement within the capped sector, were priced at approximately \$1.95/ton, by comparison.

This market dynamic demonstrates why offsets are not currently used, as the cost of abatement within the capped sector is lower than the potential options of using offsets from outside of the power sector. If this relationship were to change, then it is possible that offset protocols would become economically attractive for covered entities. Therefore, it is useful to look at the offsets regulations; as currently written, IETA believes there is an opportunity for RGGI to address issues that could hinder offset project development.

Flexible mechanisms are intended to broaden the suite of options available for facilities to comply with their obligations under the cap-and-trade program. RGGI currently allows offsets from the following five project types into its cap-and-trade program:

1. Capture or destroy CH₄ from landfills
2. Reduce emissions of SF₆ from electricity transmission and distribution equipment
3. Sequester CO₂ through afforestation
4. Reduce emissions of CO₂ through non-electric end-use energy efficiency in buildings
5. Avoid CH₄ emissions through agricultural manure management operations

There is also the potential for UNFCCC Certified Emissions Reductions (CERs) to enter the market in the event of a stage-two price trigger event. Under the assumption that RGGI will change the balance of supply and demand in the cap-and-trade program, it would be prudent to examine the gains from enabling more offsets to be used for compliance. Currently, RGGI draws solely from the aforementioned offset types, which are geographically restricted to participating states.

IETA expresses its concern with the fact that aspects of the existing protocols listed above provide project developers with high verification costs that reduce the attractiveness for undertaking offset projects. For example, under the protocol to avoid CH₄ emissions through agricultural manure management operations, there is a monitoring requirement for project owners must sample volatile solids content on a monthly basis at each project site.³ IETA suggest that, as an alternative, conservative default factors could be used, in lieu of sampling, reducing the costs for project investors. This example demonstrates the need for RGGI to look closely at their protocol rules and to

² Molly Peters-Stanley et al, *State of the Voluntary Carbon Markets 2011, Ecosystems Marketplace and Bloomberg New Energy Finance*, Pg. IV

³ RGGI Model Rule 31 December 2008, pg 124, *Regional Greenhouse Gas Initiative*



take under consideration the lessons learned from other standards and protocols in order to increase levels of investor certainty.

WHAT ARE THE OPPORTUNITIES AND CHALLENGES ASSOCIATED WITH INCREASING THE SUPPLY OF OFFSETS?

POLICY RECOMMENDATIONS

A. Increase the scope of the offsets allowed in the RGGI program to reduce emissions at a lower-cost.

RGGI has the potential to draw from a variety of sources of offset credits, based on standards and protocols used in other programs and markets. The aforementioned example of accepting CERs demonstrates RGGI's willingness to accept alternative protocols to the project types specified in the Model Rule. IETA recommends that RGGI considers the protocols from other programs, such as those approved by California Air Resources Board (ARB) for their cap-and-trade scheme, as well as approved methodologies developed under voluntary standards such as the Verified Carbon Standard (VCS) or American Carbon Registry (ACR).

Firstly, enabling offset credits issued under existing programs and standards to be converted to RGGI offset credits, increases the possibility of discovering low-cost emissions reductions. The net effect of this is to reduce compliance costs and allow the market to have access to high quality offsets from a wide array of sectors. Secondly, using credits that are fungible to other schemes allows project developers to hedge risk, by giving the option of marketing their offsets in another scheme if the RGGI market has a price that is too low or is otherwise undesirable for the project. For example, if RGGI decides to allow offsets approved by voluntary standards such as VCS, project developers are able to use credits fungible between RGGI and voluntary markets. The result is an increased level of certainty in investment for offset projects.

Additionally, if RGGI incorporates methodologies developed in other schemes, project development costs are reduced at a number of different stages. The process of developing, testing and piloting the protocols is reduced or removed altogether, which reduces the processing time for offset projects to receive issuance of credits to market, compared with using bespoke protocols not fungible to other programs. Up-front capital costs for potential offset project developers are also reduced, and these cost-savings are passed on to reduce offset prices in the market. The net effect is to reduce program costs and make offsets more economically attractive for capped facilities while achieving the same desired environmental result. Reducing capital costs and crediting cycles are particularly important during the early years of a reformed program when the initial supply of credits are introduced to the market.

Encouraging the development of offset projects from a variety of sectors also gives an economic incentive to create emissions reductions for entities not covered by the cap-and-trade program. For example, utilizing approved agricultural emissions protocols enables the sector to become a part of the cap-and-trade program and increases the scope of potential cost-effective emissions reductions to enter the scheme.

Therefore, IETA recommends that RGGI approve a greater number of protocols beyond the five types currently enabled. There are lower cost opportunities that will bring down the program's cost, which will increase savings to ratepayers across RGGI's states. Additionally, beyond increasing project types available, RGGI should enable projects to occur outside of the RGGI state jurisdictions. The benefits



of low cost emissions reductions are felt by all of the people of RGGI states, both through contributing towards reducing greenhouse gas emissions and by doing so in a more cost-effective manner than what would have otherwise been permitted. While there are co-benefits associated with domestic offset projects, they come at the expense of higher compliance costs, which are borne throughout the RGGI states.

Comparatively, in California offset protocols can be applied to projects based anywhere in the United States, Canada, and Mexico (excluding forestry projects, which must be U.S based). RGGI should consider similar provisions for its offsets regulations.

B. Consider changes to the infrastructure of the offsets program

Beyond efforts to broaden potential supply of credits into the market, RGGI should also consider the offset program infrastructure and its impact on encouraging project developers to invest in emissions reduction activities. For example, offset protocols should evolve over time, taking into consideration innovative approaches for ensuring environmental integrity and improvements to existing methodologies. IETA is concerned that offset provisions in RGGI have not been updated during the first control period, whereas in other standards and offset mechanisms there is an ongoing process of improving protocols.

Performing the administrative and operational duties of an offset regime requires significant technical capacity, as well as clearly defined rules and procedures. IETA is concerned that if the expertise is not available, ambiguities in regulatory requirements become difficult to understand, and there is a risk of a breakdown in dialogue between project developers and program administrators. The consequences of this will be a loss of investor appetite to develop projects for RGGI, preventing cost-effective emissions reductions from taking place. Complications and uncertainty have the potential to defer investment, regardless of potential returns through attractive offset prices. IETA believes RGGI should aim for an offset process that is clear and transparent, so that project developers gain confidence and certainty to operate within the market.

IETA's previous recommendation to accept credits from other standards would provide greater certainty for project developers. These standards provide the experience and technical expertise required to administer and operationalize an offsets market, and RGGI should consider these benefits when examining potential changes to the offset program.

C. Reform the current structure of the quantitative usage limit, or eliminate it altogether

IETA disagrees with the use of quantitative usage limits on offsets, as this unnecessarily restricts the options available for compliance and raises program costs. Furthermore, program and entity-usage limits would create uncertainty for offset project developers and investors with long-term planning horizons.

RGGI's quantitative usage limit creates further confusion because it is not a fixed amount. The percentage of offsets an entity is allowed for compliance increases is based on average prices for any twelve-months throughout the control period.⁴ While the limit is set at 3.3 percent, it can rise to either 5 or 10 percent if the allowance price averages above \$7 or \$10, respectively. It should be

⁴ Model Rule Revised, Section XX-6.5 (a)(3)



noted that it is unclear in the Model Rule language as to whether this refers to allowance prices in the primary or secondary markets.

Under this rule, covered entities need to depend upon price forecasts to calculate what percentage of offsets they will be able to use at the end of the control period. The presence of price volatility in the allowance market further complicates this process for both covered entities and project developers seeking to develop compliance strategies over a three-to-four year period. Finally, the adjustment of the usage limit occurs as a reaction to consistently high allowance prices over a twelve-month period, and RGGI should consider whether this enables it to be effective in providing relief to higher allowance prices.

Ideally, the total supply for offsets should be decided by market participants through price signals, rather than pre-determined in the program rules. This would create a situation in which private actors are given the greatest amount of flexibility to achieve real emissions reductions at the lowest economic cost. If RGGI decides to maintain its quantitative restrictions on offsets, then using a fixed percentage of offsets will create a greater amount of certainty for market participants. California, for example, uses a fixed usage limit of 8% on offsets. While IETA does not support a quantitative use limit, at the least the design in California enables covered entities to plan their compliance strategies with greater predictability.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF USING A COST CONTAINMENT ALLOWANCE RESERVE (CCAR) AS A FLEXIBILITY MECHANISM?

Consider potential market distortions associated with a CCAR

IETA generally cautions against the use of an allowance reserve in program design. An allowance reserve, at best, can perform a price smoothing function and reduce market risk, provided the mechanism's parameters, size, and conditions under which reserves will be released into the market are defined and certain. Under this best-case scenario, the market will effectively factor reserve dynamics and impacts into pricing. While short term price smoothing can provide a consistency signal to project developers, a CCAR does not provide any assurance of real long-term cost containment. If RGGI is committed to implementing a CCAR type of structure, it should be designed with long-term efficiency in mind, not just short term price smoothing.

In contrast, if reserve parameters and conditions are not clear to market participants, the existence and impact of the allowance reserve essentially becomes a "wild card", whereby unnecessary risk is injected into the market, debilitating the emergence of a fully functional market and impeding policy objectives.

CONCLUDING REMARKS

In summary, IETA believes that offsets serve as the most effective cost containment mechanism, providing the necessary liquidity and cost-efficient emissions reductions into a cap-and-trade program. IETA views the RGGI Program Review as an opportunity to improve the cap-and-trade rules and motivate the private sector to achieve an environmental goal at the lowest possible cost. Flexibility is a major anchor for achieving this, and IETA believes that the recommendations we have set out will enhance the flexibility of the program. IETA emphasizes that these recommendations are mutually inclusive, and taken together can build a greater amount of flexibility into the RGGI program.



Once again, on behalf of IETA and our member companies, I would like to thank you for your attention to these comments. Please do not hesitate to contact either myself, or Anthony Mansell (Mansell@ieta.org) with questions.

Sincerely,

Henry Derwent
President and CEO