



COMMENTS OF ENVIRONMENTAL DEFENSE
ON THE
REGIONAL GREENHOUSE GAS INITIATIVE (RGGI) DRAFT MODEL RULE

Environmental Defense is a non-profit environmental organization with 400,000 members. Our staff includes economists, scientists and public policy experts who have deep experience in the design and implementation of emissions trading programs. We applaud the states of Connecticut, Delaware, Maine, New Hampshire, New Jersey, New York, and Vermont for completing the RGGI Memorandum of Understanding (MOU) and working on the draft rules. We look forward to Maryland moving ahead on the program and hope that Massachusetts and other states will follow suit. Climate change is one of the most daunting challenges facing the planet. The RGGI states have taken an enormous step in taking responsible action to address climate change. Environmental Defense looks forward to working with you to complete the model rule process.

At its core, the RGGI program sets a cap on emissions and allows the use of market mechanisms including emission trading and the use of emission offsets in order to implement the program cost effectively. Environmental Defense is a strong supporter of the use of market mechanisms in cases where the programs are well designed and are appropriate to address the environmental problem at hand. We believe that this is especially the case for climate change because significant reductions are going to be needed globally and from virtually every sector of the economy. Emission trading provides incentives for innovation and participation across sectors. These are important factors in actually achieving serious climate change reductions and in ensuring the cost-efficiency of reductions programs.

Emissions trading programs are effective when they are properly designed. Critical features of successful emission trading programs include the creation of a firm and meaningful emissions cap. Setting a cap at a level that represents actual reductions from contemporaneous levels of emissions stimulates demand for emission reductions. Transparency and access to information helps the market to efficiently assess demand and work to meet that demand with adequate supply. A key feature of this approach is an accurate and long-term price signal – one that is allowed to weather the volatility inherent in new markets such as was experienced in the start up of the US Acid Rain program and as seems to be happening in the European Union Emission Trading System (EU ETS) market. For this reason, Environmental Defense is strongly opposed to price caps and even to the safety valve mechanism in the RGGI model rule. In our opinion, the best program would set firm caps and stringent criteria for the creation of high-integrity offsets. With both of these in place we believe that sources should be allowed to use an unlimited number of offsets as part of their compliance strategy and this measure would

be the most effective way to control costs while also achieving greenhouse gas reductions. We realize that the RGGI states have opted not to follow this path and so we offer the following comments based on the structure described in the RGGI MOU.

General Comments:

Emission trading relies on market forces to function. Therefore, any program design feature that undermines normal market forces needs to be carefully considered. Environmental Defense's preference is to look for market-based options to alleviate specific concerns such as cost, rather than to impose artificial price signals or other market interventions. To this end, as stated above, our primary concern with the model rule, and with the MOU, continues to be the price-based safety valve mechanism. As we will describe in detail below, the provisions for the safety valve add unnecessary complexity and thus transaction cost to the program. Worse, they create opportunities for gaming the system. These will lead to increased uncertainty about the future requirements which will directly undermine the effectiveness of the program. The Staff Working Group (SWG) should eliminate the safety valve triggers altogether. If the SWG is unable to eliminate the triggers, the SWG should, at a minimum streamline the process to eliminate the \$7 trigger and create a more robust and transparent mechanism for determining if the trigger threshold has been met. The market mechanism of trading coupled with access to high quality offsets, will do more to reduce cost concerns than an approach such as a safety valve.

We are also generally concerned about the integrity of the emissions cap. It appears that a number of sources that were included for purposes of calculating the caps will potentially be eligible for exemption from the program. We do not support these exemptions and think they should be removed from the rule. At a minimum, the caps should be reduced by the amount of emissions represented by any sources that are exempted from the rule. Finally, we are generally concerned that the rule does not explicitly address several of the important issues related to the operation of the offsets provisions that are described in the MOU but that do not easily lend themselves to codification in a state-by-state rule. We think it is important to anticipate as much of this as possible in the rule and offer some suggestions below.

Specific Comments on the Model Rule:

These detailed comments start at the beginning of the rule and go through it section by section. They are followed by a larger discussion of the offsets program which draws on sections from throughout the rule and also offers suggestions for new language.

1. Purpose – Section XX-1.1: This section should explicitly include the criteria necessary for ensuring the integrity of offsets which are included in the MOU. Those criteria call for reductions that are real, quantifiable, surplus, enforceable and permanent. The model rule seems to implicitly acknowledge these criteria in the standards for creating offsets in subpart XX-10. However, since it is contemplated that other types of offsets and other standards may be included in future versions of the rule, it is critical that the model rule

explicitly include these criteria and require that all standards for the creations of offsets demonstrate to the satisfaction of the state how these criteria will be met for each type of offset.

These criteria can not be interpreted with “black and white” precision. For example, there may be several ways of demonstrating the “permanence” criterion of “permanent” for afforestation offset credits that satisfy potentially competing concerns about environmental integrity and cost. The test for permanence in afforestation credits will likely end up being very different than the permanence test for SF6 controls. Yet different standards for both types of offsets could be designed to yield high environmental integrity. For this reason, it is appropriate to define each of these five criteria specifically for each offset type as part of the offset standards in Section XX-10.5 rather than defining the five criteria in a generic way elsewhere in the rule.

A problem for the states involved in RGGI is that there is no central authority to determine whether these criteria are met for new types of offsets. For this reason, we believe that future offset types and corresponding standards will need to be added to the program through an MOU and rule making process. In the absence of such a negotiated procedure, we fear that there will not be a consistent interpretation of the quality criteria among the states implementing RGGI.

We suggest that section XX-1-1.1 be modified to include a new text that reads something like this: This rule allows for the limited use of offsets for compliance purposes provided such offsets conform to the project specific performance standards that are designed to achieve the goals of having offsets that are real, surplus, verifiable, permanent and enforceable. These goals will apply to any new offset types added in the future and will be included in any new offset standards developed for this program.

2. Modifications to the Definitions Section XX-1.2:

h. CO₂ allowance – The definition of CO₂ allowances describes it as: “A limited authorization by the REGULATORY AGENCY under the CO₂ Budget Trading Program to emit up to one ton of CO₂ during the control period in which its allocation year falls.” Since CO₂ offset allowances seem to be treated as allowances but do not have an allocation year, the definition needs to be clarified. Further, we suggest that two additional terms for early reduction credit allowances and offset allowances be created. Since CO₂ Allowances can be banked and used in future years, the reference to limited use during the year of allocation is confusing. The definition should reflect the opportunity to bank CO₂ Allowances or the definition should be modified so that it does not describe its use. In addition, the rule should describe the method for identifying these instruments which might include an alpha numeric system. This system should be coordinated throughout the region so that any single allowance would have a unique RGGI identification. The purpose for this is to increase the transparency of the program and to avoid confusion. We recommend that the definition be modified to include bracketed text, much like the text in section XX-1.5(a) and other places within the rule, to read **[INSERT EACH STATE’S RANGE OF SERIAL NUMBERS]**

q. CO₂ budget source – This definition includes sources that may potentially opt to be exempted from the program. Yet, it seems that the rule’s intent is to require continued reporting from exempted sources in order to ensure that they continue to qualify for the exemption in the future. Therefore the definition of CO₂ budget source should focus on boiler size or some other unmalleable trait, (e.g. all boilers over 25MW)

az and bb. Stage 1 and 2 Trigger Events – The definition implies a procedure to determine if the event has occurred. However, this procedure is not described in the regulation. As noted above, we recommend that the triggers should be eliminated from the rule altogether.

3. Applicability (Section XX-1.4(a)): The definition of unit includes only those facilities that burn 50% or more fossil fuel. This definition excludes facilities that burn more than 50% biomass from the rule. Such facilities are required to report their fuel mix under section XX-8. It is not clear if new biomass plants would be subject to the reporting requirements. They should be explicitly included. Further, the definition should not be based on percentage of fuel mix but rather on amount of net greenhouse gas emissions: A very large biomass facility might have net greenhouse gas emissions that are greater than a smaller fossil fuel fired plant. Any biomass plant that meets certain thresholds of size and net annual greenhouse gas emissions per year should be included in the program. For example, a boiler size of 25MW or annual net greenhouse gas emissions of 10,000 tons per year are both reasonable thresholds for inclusion in the program and a requirement for annual reporting.

4. Applicability (Section XX-1.4(b)): This section allows a limited exemption for CO₂ Budget Sources that supply less than 10% of their power to the grid. We do not believe that such sources should be exempted from the program. If they are large industrial boilers then their contribution of CO₂ would be equal to other boilers used to fully supply the grid. If the state chooses to exempt such sources then the cap must be reduced in an amount equal to the emissions from those exempted sources.

5. Standard Requirements (Section XX-1.5 (c)(6)): This section should clearly indicate the difference between allowance types. As indicated in our concerns about the definition of “CO₂ allowance”, this section does not distinguish between allocated allowances, early reduction allowances and offset allowances. Yet there are different rules for using at least offsets. Those distinctions need to be recognized in this section in order to provide transparency and avoid confusion.

6. CO₂ Allocations (section XX-5.3(c)): While as a general rule Environmental Defense does not believe it is essential to deduct early reduction credits (ERCs) from a future cap, modeling shows that the cap in the early years of the RGGI program may not actually be binding. Hence, we believe in this instance that ERCs could be deducted from the future cap without imposing an excessive burden on participants in the program. We are also concerned that some sources may be required to make reductions or improvements in energy efficiency during the early reduction period of 2006-2008. We request that the baseline for early reduction credits be modified so that it is the lower of actual average emissions during the period 2003-2005 OR the level of emissions achieved after

complying with any requirements for emissions reductions or efficiency improvements during the period 2006-2008.

7. *Serialization (Section XX-6.4(c))*: The rule should indicate a coordinated serialization scheme assigned to each state such that every allowance would have a unique identification throughout the RGGI region and so that allowances would be easily distinguished by type and year. The reason for putting this into the rule is to enhance transparency, for example, so that market participants have the ability to do their own due diligence before undertaking trades.

8. *Compliance (Section XX-6.5)*: Given the differing rules for using offset allowances contained in this section, we believe it is important to carry the distinction throughout the rule by creating at least two, if not three, distinct categories of tradable instrument: CO2 Allowances, Early Reduction Allowances and Offset Allowances. We also believe rules for using offsets if the triggers have been met should be changed as described below.

9. *CO2 Allowance Transfers (Section XX-7.1 (d) and (e))*: These sections require sources to report the last transacted price and the current transaction price for allowances being transferred. To the extent sources either wish to game the system or simply to protect what they may consider to be sensitive information (price), we are concerned that a secondary reporting structure may develop in which transactions are acknowledged through contract but not recorded until a later date in the official registry. This would present a gaming opportunity. Further, we are concerned that there are no penalties for false reporting of price information. Given the recent experience of price reporting in the natural gas market, we believe that such penalties need to be explicitly included in the rule, and that they should be designed to provide a credible deterrent to false or misleading reporting.

OFFSETS

Environmental Defense strongly supports the use of offsets as a means to control compliance costs for regulated sources, to provide incentives for reductions and innovations in sectors not regulated by the program and to encourage broader participation in RGGI – potentially by non-regulated sectors and by new states.

Our support for offsets is predicated on the following criteria for the design of the offset program:

- That there is transparency in the creation and use of offsets in order to facilitate the completion of due diligence analysis by market participants, to discourage gaming and to provide the broader public with a means of evaluating program performance.
- That the standards for creating offsets adequately demonstrate that the reductions will be real, quantifiable, surplus, enforceable and permanent.
- That there be consistency across the RGGI states regarding the creation, use and tracking of offsets.

- And, that the program strives to minimize associated transaction costs where feasible.

The RGGI MOU and model rule goes a long way towards creating an offset program that meets these criteria, but some concerns remain. We offer the following comments in an effort to improve the offset component of the RGGI model rule. These suggestions reflect two concerns about the draft model rule: First, there is no mechanism to ensure that the RGGI states act in unison to determine if a trigger threshold has been met. This raises the possibility that one state may make such a determination on its own. Second, there is no mechanism to challenge the validity of the reported pricing information or to prevent gaming based on the timing of reporting.

10. Offsets Purpose (section XX-10.1): As indicated above, the rule should explicitly state the criteria for offset standards of real, quantifiable, surplus, enforceable and permanent. We suggest that section XX-10.1 be modified to include a new text that reads something like this: This rule allows for the limited use of offsets for compliance purposes provided such offsets conform to the project specific performance standards that are designed to achieve the goals of having offsets that are real, surplus, verifiable, permanent and enforceable. These goals will apply to any new offset types added in the future and will be included in any new offset standards developed for this program.

11. Eligible CO2 emission credit retirements – Section 10.3(b): This section is confusing. It appears to reference the EUETS and the credits created through the Clean Development Mechanisms (CDM) process. If so, the section should refer to these programs explicitly or establish criteria for programs that qualify to provide credits to RGGI. Further, we are concerned by recent reports about inflated caps and allocations in the EUETS and think there should be further consideration given to whether it is appropriate to use such credits from the 2005-2008 period in RGGI. Perhaps it would make most sense to allow EUETS allowances that are still valid for use after 2009.

12. Award of Offset Allowances (section XX-10.7(1)(i): We believe it is unnecessary to discount allowances from non-Participating states. Given that we view the offset standards to be sufficient to ensure the environmental integrity of offsets, given the exceptions described below, we urge the SWG to modify the rule to credit offsets on a one to one basis if they were created in non-Participating states that have adopted a greenhouse gas cap from large stationary sources, have adopted a cap for the sector creating offsets, or are willing to create an enforceable regulatory instrument governing the creation of offsets or otherwise help to ensure the integrity of the reduction. These offsets should be eligible for use in compliance on a 1:1 basis from the onset of the program.

13. We request that the SWG add a new section or language to an existing section of the rule making false reporting of price information a violation. This language should include strict sanctions for false reporting and should also include any provisions necessary for the state to investigate and prosecute such violations.

14. We request that each state commit to post a quarterly price and volume report for transacted allowances, offsets and early reduction credits.

Comments on the “safety valve” trigger concept as applied in the Draft RGGI Model Rule

As noted above we oppose the use of safety valve triggers because we believe that they are unnecessary to assure quality emissions reductions and because they add complexity and uncertainty to the program. We therefore recommend that the SWG eliminate these provisions from the final Model Rule. We offer the following three comments in the event that the SWG does not follow our primary recommendation on this issue.

15. If the trigger concept is retained, we request that each state commit to using a Reference RGGI index, similar in concept to the CPI (consumer price index) referenced in definition of “Stage One Threshold Price” of the definitions section, as a means for determining if a trigger event threshold has been met. The RGGI index could be determined by the RGGI body described in the MOU. As an alternative, the draft rule should define a process through which the state will evaluate the posted reports from other RGGI states and possibly from several additional posted indexes to determine if a safety valve trigger event has occurred. We do not believe that either of these approaches would compromise state sovereignty.

16. The mechanism for determining if a trigger threshold has been met should provide an opportunity for the general public and the market to comment on whether the reports accurately reflect the status of the market.

17. If they are not eliminated, the multiple “safety valves” should be streamlined into one threshold / event. New markets are volatile markets. Even though we do not have concerns about the costs for compliance with the RGGI program being unreasonably high over the long-term, we are keenly aware of volatility during the first year of operation of the European Union Emission Trading System (EUETS) and have some concern about the potential for volatility in the RGGI market as the program gets started. We think that the “Stage One Threshold Price” of roughly \$7 (as adjusted) is too close to the current range of prices for offsets being traded on a voluntary basis in the US. Therefore, we think this threshold is simply too low for a newly starting market. There is significant potential for a delay in the reporting of transactions, creating situation where a small number of transactions have a large impact on the average RGGI allowance price. We suggest that the “Stage One Threshold Price” and “Stage One Trigger Event” be eliminated altogether along with the corresponding provisions throughout the rule for allowing the use and creation of offsets. We also suggest that the baseline level of offsets allowed be equal to 5% of actual emissions during the budget period for compliance.

Since Environmental Defense generally thinks the offset standards are sufficient to ensure the integrity of related offsets, we think that the SWG should also reduce the complexity of the rules governing the use and creation of offsets if a “Stage Two Trigger Event” occurs twice in a compliance period. Instead, if the SWG retains safety valve

trigger mechanism, we urge it to create one safety valve mechanism that is set at the current “Stage Two Threshold Price”. If it is determined that this threshold (roughly \$10 as adjusted) has been triggered then:

- the compliance period should be extended one year, and one year only;
- sources should be allowed to use offsets in an amount equal to 10% of their actual emissions during the budget period for compliance. This number is derived from a review of the proposed cap on allowance use proposed in the draft model rule. Under the draft model rule’s provision, sources would be allowed to use allowances in an amount equal to 5% of actual emissions for the first three years of the budget period and up to 20% for years four through six depending on the optional extended compliance period. This would be a range of 8.75-12.5% depending on how long the compliance period was extended. We propose simplifying the system by limiting the extension to one year and using a constant percentage throughout the compliance period.

18. Offset Types and Standards: The rule should anticipate the addition of new types of offsets and accompanying offset standards by indicating the procedure to adopt new offset types. Environmental Defense would support an MOU and draft rule process or a process that relies on the RGGI body to approve new offset types and standards. We think it is important for RGGI to actively seek new types of offsets for inclusion in the program. Such incentive will help to keep the cost of allowances down and will provide continuous incentives for new technologies and innovations to vie for admission to the RGGI market. We are aware that some parties have already suggested new types of offsets for inclusion including forest sequestration through conservation and avoided CO2 emissions from the capture and use in enhanced oil recovery operations. Generally, Environmental Defense believes that standards for creation of both of these types of offsets can be developed in a manner that ensures the environmental integrity of the reductions while also providing incentives for other states to become involved in RGGI. We are also interested in exploring the potential for allowing offsets from methane avoidance (as opposed to capture from existing sources) to be considered as an offset type.

19. *Afforestation Standards (Section XX-10.5 (c)):*

Afforestation projects can potentially provide an important source of Offset Allowances for the RGGI program. In addition to reducing carbon in the atmosphere they can provide additional benefits such as erosion controls, habitat improvements (biodiversity) and other air and water quality benefits. We believe that the opportunity to create Offset Allowances may stimulate actions that would not otherwise occur. For these reasons, we are concerned that the proposed standard may set too high a bar. Instead of encouraging quality offsets, the degree of difficulty in demonstrating compliance with the proposed standards may discourage sponsors from developing afforestation projects for RGGI. Specifically:

Section (1) Eligibility - (iii) requires projects to be “managed in accordance with environmentally sustainable forestry practices.” This language leaves a decision about compliance with the requirement open to broad interpretation. We suggest

an alternative that requires that the landowner agrees to adopt state best management practices for all forest activities. We recognize that there is some discrepancy among the states, but at least these criteria would be clear for each state.

Section (4) Calculating Carbon Sequestered (ii) Calculating net change.

The measurement system as described does not explicitly allow measurement to be accomplished through sampling across multiple properties. Spreading measurement costs across several tracts will allow a project developer to get better economies of scale. Landowners ought to be able to aggregate their lands with other landowners and share the costs of measurement. We suggest that the regulations specifically allow for measurement by sampling across multiple properties.

(iii) 20% discount for potential losses of sequestered carbon.

While we support the need to be conservative and to protect against potential losses of sequestered carbon, we feel that this 20% discount is arbitrary and unnecessary. A better option would be to take the lower bound of the confidence interval, which creates incentives for better measurement and takes a conservative approach.

(ii) (c) FSC and SFI

FSC and SFI standards are applicable to land that is managed for harvesting. We recommend that these practices be asked to be consistent with these standards only if they are actively managed for harvesting.

Section (6) Carbon permanence - Conservation easement requirement

We agree that permanence is a key requirement to any afforestation offset and while we support easements in other policy frameworks, it does not serve the purposes of this carbon reduction program. Easements do not guarantee the permanence of a carbon stock; permanence is only solved by having an on-going accounting system which tracks carbon stores. Additionally, because of the inflexibility and complicated nature of conservation easements, using a conservation easement as a proxy will dramatically increase entry costs for landowners and limit landowner participation. For this reason, we suggest offering two options.

Option 1. Require a permanent conservation easement

Option 2. Require afforestation agreements to be term agreements (10 years, for example). At the end of the term, the purchaser of the offset must prove that the carbon stores still remain. If they do, the purchaser has the option to renew the credit. If they do not or if the purchaser wishes to use the land for other purposes, the purchaser is responsible for replacing the cumulative carbon generated by this offset from other sources.

20. Avoided Methane Emissions from Agricultural Manure Management Options
(Section XX-10.5 (e)):

Section 1 –Eligibility – Section (e)(1)(i) the first paragraph refers to organic food waste as described in Section (e)(1)(iv) – there is no such section in the subdivision. It appears that the rule meant to refer to Section (e)(1)(iii) instead. If correct, this should be fixed in the rule. If not, this should be further explained.

Section 1 –Eligibility – Section (e)(1)(ii) defines eligible projects as consuming at least 50% manure. We are aware of some anaerobic digesters that require high solids content and so may take a smaller fraction of manure. We believe that such processes should be able to qualify for reduction credits for the portion of the reductions attributed to manure digestion.

Section 3 – Calculating Emission Reductions (e)(3) We agree that regional digester operations should be included in the offset standard and request that section 3 be modified to reduce the amount of emission reduction credited as offsets by the amount of CO2 emissions associated with transporting the manure to the regional digester.

General Comment: The digestate from the processes described in the standard will likely contain high levels of ammonia which can easily volatilize if not handled properly. The offset standard should include a requirement that project sponsors demonstrate that the digestate will be handled properly in order to contain the ammonia.

Thank you for considering our comments; we would be happy to provide additional information or answer any questions.