



To: Carbon Allocation Task Force
From: Stacey Davis and Mac Wubben, CCAP
Date: May 25, 2006
Re: Straw proposal on offset design for discussion on June 1, 2006

This straw proposal responds to the questions posed in April related to the inclusion of offsets under a load-based trading program in Oregon. This proposal draws from discussions held with various Oregon stakeholders as well as some of CCAP's own views on a possible "middle ground" program design. As such, this proposal does not reflect an optimal offset program design, nor does it represent the view of any particular stakeholder or CCAP. The goal of this straw proposal is to elicit discussion and, potentially, placeholder decisions on specific offset program design elements as part of a larger offset package within the load-based trading framework.

1. Should offsets be allowed?

Yes, but with limits and provisions to ensure high quality.

Rationale: Offsets have the potential to lower costs, increase compliance flexibility, motivate actions in multiple sectors, and encourage early reductions. In theory, they capture the most cost effective emission reduction opportunities regardless of the sector. Offsets can also provide price discovery on compliance costs. However, there are concerns about whether offsets can be shown to be real and additional. There is also a desire by some stakeholders to ensure that emissions reductions come from within the regulated power system.

2. Should the amount of offsets be limited?

Yes. The total number of offsets should be limited to 25 percent of the required reductions from the baseline.

Rationale: This limit is a compromise position that ensures that a significant share of compliance will be met within the electricity sector while also providing benefits associated with an offset program (e.g., low costs, flexibility, multiple sectors, early action, and price discovery), though at a smaller scale. An offset limit based on a percentage reduction from the baseline is administratively simple and provides a high degree of certainty to industry and offset developers. However, there is an open question on how markets will react to these limits. In particular, is an Oregon market equivalent to ¼ of the reductions from the baseline (about 1 MMTCE in 2020) large

enough for the private sector to respond with offsets? Note that many stakeholders wanted no restrictions and others proposed tighter restrictions.

3. Should offsets be limited geographically?

Yes. A minimum of 50 percent of the offsets should come from Oregon.

Rationale: Capturing the co-benefits from offset creation and developing a lower-carbon economy within Oregon are goals requiring that offsets be limited to Oregon. However, there is a tradeoff between cost of offsets and geographic scope, with broader scope allowing for lower costs. A 50 percent limit will serve to capture many of the co-benefits and help Oregon reduce its carbon footprint while holding costs down.

4. Should offsets value diminish over time or expire?

No. Offset projects should receive credits for emissions reductions according to the applicable baseline definitions and sector rules for up to a six year period. If the offset project continues to yield reductions after the sixth year, it can be renewed, but may be subject to new baseline definitions and sector rules. Therefore, in years 7 through 12, fewer credits may be awarded for ongoing emissions reductions, if any, achieved from the same project. Alternatively, to increase certainty and lower administrative costs, an offset could be awarded credits for a 9-year period without opportunity for renewal. In either case, once credits are awarded, their values are maintained.

Rationale: Limiting the lifetime of a credit or discounting its value over time discourages offset creation. Thus, once the credits are awarded, they should not diminish in value. Moreover, as long as offset use is not at the ceiling and banking of allowances is allowed, offset expiration would not be meaningful as regulated entities would choose to use offsets first and bank allowances. The renewable 6 year period and non-renewable 9 year period for granting allowances for a given project acknowledges that offset standards change over time. For example, a measure that is additional today (e.g., from a regulatory standpoint) may not be in 6 years.

5. Which sectors should be allowed to earn offsets?

The state should establish rules for offset projects in high priority sectors. For example, the state should develop standardized baselines and offset requirements in cases where 1) sectors are unlikely to be regulated in the future (e.g., direct emissions from small landfills, biodigesters and the residential oil sector, existing transportation), 2) significant cost-effective emissions reductions opportunities are expected (e.g., cement), and/or 3) a given project type is politically important (e.g., afforestation/reforestation).

In certain instances, offsets should not be allowed because of additionality issues (e.g., forest preservation), measurement difficulties (e.g., below ground soil carbon storage), and alleged cheating (e.g., HFC offsets from outside the country). In addition, measures that are “inside the power sector cap” such as in-state energy efficiency projects that displace electricity and renewable energy sold to Oregon LSEs should not be granted offset credit. Renewable energy projects where the power is not delivered to Oregon (e.g., unbundled RECs) should also not be granted offset credit, or if it is, the additionality restrictions should apply and the carbon value of these credits should not exceed that of bundled RECs sold to Oregon.

In other cases, sectors would need to petition for the development of a standard protocol or for approval on a case-by-case basis. *Importantly, while offsets should be allowed from a variety of sectors, all offsets should be subject to strict permanence, additionality and high threshold baseline requirements, particularly where future regulation is likely, as described in the following sections.*

Rationale: This recommendation seeks to balance a desire not to pick winners and to allow the market to identify low cost mitigation opportunities with the reality that many types of potential offset projects will not move forward due to high transaction costs for project development and may therefore not warrant the a priori time and resources required to develop offset baselines and sector rules.

Earning offsets from energy efficiency and renewable energy measures within the power sector are explicitly disallowed as they would result in double counting of power sector reductions under a load-based trading program. Under a load-based trading program, energy efficiency and renewable energy comprise core means of compliance with the cap. Renewable energy that is owned by or sold to an Oregon LSE is already reflected in that company’s bottom line emissions. Therefore, additional “credit” cannot be granted for these activities. Similarly, to the extent that an Oregon LSE or its customer invests in energy efficiency to reduce the demand of one of its power customers, this will reduce the total amount of power it needs to supply and the emissions associated with that power supply. To the extent that this energy efficiency or renewable energy seeks to earn independent “credit,” this would be double counting.

If the energy efficiency and renewable energy project seeking to earn “credit” is not owned by or sold to an Oregon LSE, or is not achieved by a customer of the LSE, then these reductions are technically outside the boundary of the cap-and-trade program. As such, Oregon offset “credit” could be granted for energy efficiency projects outside the state. However, renewable energy projects outside the state pose special challenges.

If a renewable energy project outside the state could be delivered to an Oregon LSE, then allowing it to earn offset “credit” could create a perverse incentive in which it

becomes more advantageous to buy an “unbundled REC¹” from out-of-state than establish a long-term contract for bundled renewable energy. In fact, depending on how the carbon reductions from a given REC is valued, a REC from a coal state such as Wyoming could be credited as being of higher value than renewable energy in OR. In addition, use of unbundled RECs could lead to compliance via “contract shuffling” in which existing renewable energy attributes from far flung parts of the West are sold to Oregon, without any change in behavior.

Use of unbundled RECs, then, potentially runs counter to the goals of 1) achieving additional carbon reductions (due to the potential for contract shuffling) and 2) undertaking measures (long-term contracts for bundled power) that will better position Oregon in the long-term to respond to tighter climate regimes. In addition, granting Oregon offset “credit” for power sector mitigation actions outside of the cap (and not doing so within the cap) would likely be deemed unfair and would potentially be illegal under the Commerce Clause.

If a policy decision is made to allow unbundled RECs as offsets, it would be important to ensure that their carbon value is at most equivalent to bundled renewable energy sold to OR. In addition, unbundled RECs should be required to meet the additionality tests described below. Other policy questions such as the location of RECs and the definition of renewable energy would also need to be resolved.

6. How should permanence be addressed?

Afforestation/Reforestation projects should be issued renewable temporary credits good for six years. These credits can be replaced with permanent credits at any time or they can be renewed at the end of the six year cycle provided that the sequestered carbon has not been released.

Rationale: Unlike other types of offsets, the accrued value of afforestation/reforestation offsets can be completely wiped out if the trees are destroyed or removed. A limited time horizon for using afforestation/reforestation offsets helps ensure that any “debt” can be paid back in the event that sequestration is lost due to natural or human-induced causes.

7. How should additionality be addressed?

We suggest a system that first disqualifies projects that are clearly not additional using three simple tests. Then, the remaining projects are compared against a top performing industry standard. Reductions beyond this standard are creditable as offsets.

All of the following tests must be met:

¹ This term is being used to refer to renewable energy attributes that are sold separately from the power generated by the renewable energy.

- a. **Regulatory Test**—all awarded credits must be for emissions reductions above and beyond those required by regulation or legislation.
- b. **State Incentives Test**—credits may not be awarded for projects paid for in part or in full by state government incentives.
- c. **Timing Test**—credits may not be awarded for projects that begin before enactment of legislation.

With these tests met, credits will be awarded based on emissions reductions below a “top-performing” baseline for the applicable sector or project type, defined as the top 20th percentile. Only reductions in excess of what is achieved by the top 20th percentile would earn credits that could be sold into the trading system.

Rationale: Additionality provides the integrity of an offset program. While it is relatively straight-forward to prove something is not additional, proving additionality involves proving a counterfactual (i.e. that the project would not have occurred in the baseline). Some of the tests used to “prove” additionality such as the “financial barriers test” are quite subjective and open to interpretation. This test seeks to show that the project would not have happened but for funds from offset revenues. Not surprisingly, it has not been difficult for projects to demonstrate that support from offset revenue generation has been essential to project development, thereby passing the additionality test.

A combined system of tests and aggressive performance standards performs as well as the additionality tests without the administrative burden or potential for gaming, and also encourages high performance in GHG mitigation. This system motivates improved efficiency and has a high degree of environmental integrity. The drawback of this system is that it rewards the most efficient offset producers that undertake offset projects regardless of the reason for their efficiency.