



## **USCAP Recommendations and Options on Offset Quality, Early Supply and Early Emission Reductions from Industrial Sources <sup>1</sup>**

### **Executive Summary**

Ensuring a smooth and orderly transition to a low carbon economy is imperative. A comprehensive policy contains costs while ensuring necessary investment in new technologies and actual emission reductions. High quality domestic and international offsets will help achieve these goals, as will rewarding and encouraging actions taken to reduce greenhouse gas emissions prior to enactment of legislation.

USCAP's *Call for Action* and our *Blueprint for Legislative Action* address these issues. To provide additional detail, USCAP has developed new recommendations and options for securing a robust supply of high quality offsets, especially in the near term and for encouraging continued early action to reduce emissions.

To ensure a substantial supply of offsets are actually available in the early years of the program, we recommend:

- Criteria for early offset eligibility that is established by U.S. Environmental Protection Agency (EPA) prior to enactment of legislation should be incorporated into final legislation in order to ensure an early supply of offsets.
- The administrator of the final offset program should also start to develop final offset provisions prior to enactment, by building on the existing programs and methodologies for eligible early offsets.
- Increasing relevant federal agencies' technical capacity to achieve these goals.

To ensure that these early offsets are quickly followed by a continued, ample supply of high quality offsets, we recommend Congress:

- Establish clear and consistent definitions of key GHG offset quality criteria.

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<sup>1</sup> These recommendations were developed under an assumption that there will be an economy-wide cap-and-trade program that takes effect in 2012 and includes the industrial sector emissions in 2014. The support of all USCAP for the recommendations included in this paper will be affected by the interrelated nature of the policy details in the specific legislative package under consideration, including the scope of coverage for the cap and the timing of implementation.

- Include a priority list of offset project types for consideration and scientific evaluation by the offset program administrator.
- Provide high level guidance that vests responsibility for technical decisions with the offset program administrator wherever possible.
- Allow for offset program evolution and flexibility over time.
- Ensure that the regulatory development process of the offset program is open to the public and conducted in a transparent and timely manner.
- Ensure emission reduction credits sourced from sequestration projects properly address and account for the risk of reversal or loss of stored carbon.
- Ensure that international offsets are an integral part of a high-quality supply of regulatory offsets for use in the U.S. climate program

Legislation addressing early action should build on the *Call for Action* and *Blueprint for Legislative Action* with the following steps:

- Set aside an adequate number of allowances to recognize early action taken at domestic facilities between a given year (e.g., 1995) and the date of enactment, regardless of whether such entities or facilities will ultimately be regulated under the cap. We recognize that it is difficult to determine the size of a set-aside of allowances adequate to provide credit for early actions that meet necessary quality criteria.
- Provide credits for accelerated reductions (CARs) for industrial facilities that will be subject to the cap. Such credits would be similar to the early offset credits included in the House-passed bill. They would provide additional financial incentives—beyond simply reducing an entities’ compliance obligation – for entities to initiate emission reduction activities (or to continue reversible ones) prior to being regulated under the cap. CARs should be subject to an overall limit on offsets of no more than 2 billion tons per year at the outset of the program.
- If Congress does not provide an adequate set-aside of credits for early action, we introduce two alternatives, which USCAP members have not reached consensus on but may be of value to policy makers, including: a) ensuring that the allocation formula for covered industrial facilities recognizes early action; and b) including high quality early action reductions from 2005 to the date of enactment under the early offsets program, specifically as CARs, subject to a limit of no more than 150-200 million tons with a starting date of no earlier than January 1, 2005.

We believe the additional details provided in the recommendations and options paper will provide additional guidance as legislation moves forward. We look forward to working with Congress, the Administration and others to pass environmentally protective, economically sustainable and fair climate change legislation.

## **A. Introduction**

USCAP strongly supports the inclusion of an adequate number of high quality greenhouse gas (GHG) offsets in U.S. climate policy. This document provides recommendations organized around several key topics:

- Section B addresses general GHG offset policy design principles to ensure quality, consistency, accessibility, and adaptability over time in the regulatory offset program;
- Section C addresses steps that the federal offset program administrator should undertake in advance of the enactment of climate legislation that will ensure a ready and adequate supply of offsets;
- Section D provides a framework for a domestic and international early offset supply program that will provide a high degree of quality assurance and critical supply and liquidity early in the offset program;
- Section E includes recommendations for recognizing and encouraging early emission reductions from industrial sources;
- Section F addresses the relationship of any potential New Source Performance Standards and GHG offset crediting periods; and
- Section G includes recommendations regarding the role and importance of various international offset credits and programs.

## **B. Principles to Ensure Accessibility, Consistency, Quality and Adaptability in the Regulatory Offset Program**

- 1) *Establish clear and consistent definitions of key GHG offset quality criteria.* This includes robust provisions to address additionality, leakage, impermanence, verification and uncertainty through standardized, transparent methodologies. These provisions are intended to provide assurance that all offsets used in the program represent high-quality emission reduction projects. As such, these criteria should apply to all offset methodologies and credits issued by any federal agency. Furthermore, these quality criteria should not unduly delay new offset project types that may be certified on a case-by-case basis until standardized methodologies have been established.
- 2) *Include a priority list of offset project types in legislation for consideration and scientific evaluation by the offset program administrator.* This list of “off the shelf” offset project types and methodologies would be subject to expedited review by the offset program administrator.
- 3) *Provide high level guidance in legislation that vests responsibility for technical decisions with the offset program administrator wherever possible.* The program administrator’s responsibility should include the identification of eligible offset project types and the development of science-based qualification and quantification methodologies and protocols. This approach will ensure that these critical design elements are crafted

through a publicly-accessible, scientifically-informed and transparent rulemaking process with input from scientists and technical experts.

- 4) *Allow for offset program evolution and flexibility over time.* Climate policy should allow for both the addition and removal of eligible offset project types over time. This is an important element of ensuring emission reduction or sequestration projects receiving offset credit generate real, additional reductions of greenhouse gases beyond what otherwise would have occurred. In the event that a particular project type is deemed no longer eligible for compliance use, approved offset projects of that type should be allowed to complete their crediting periods. Furthermore, offset crediting should be accomplished using both standardized methodologies and the application of offset quality criteria to project-specific data. Finally, regular review, evaluation and adjustment of the offset program should be performed in a manner that does not result in duplicative review of offset projects.
- 5) *Ensure that the regulatory development process of the offset program is open to the public and conducted in a transparent and timely manner.* As part of its process for identification of acceptable offset project types and methodologies, the offset program administrator and any offset advisory board established should solicit public comment for consideration in the development of the initial eligible offset project list and subsequent regulations.
- 6) *Include provisions to ensure emission reduction credits sourced from sequestration projects properly address and account for the risk of reversal or loss of stored carbon.* Climate policy should provide rigorous provisions that include clear legal responsibility for reversals and ensure that emissions are properly accounted for in the event of a sequestration project emission reduction reversal or loss. Potential mechanisms to address reversals or loss include, but are not limited to the appropriate use of buffer accounts, insurance mechanisms, and credit replacement requirements.

### **C. Pre-Enactment Activities Are Needed on Offsets**

Any appropriation or other support needed for the relevant agencies to ensure rapid completion of the tasks listed below should be provided through legislation or another appropriate legal mechanism. Congress should ensure that any criteria for early offsets that is promulgated by relevant federal agencies prior to enactment of comprehensive climate legislation will be incorporated into the final climate legislation. Specific steps that are necessary to assure an adequate supply of high quality offsets and credits for early action include:

- 1) *Developing approval criteria and identification of existing offset programs and methodologies (as described in Section D below) that will be eligible under the early offset program.* The offset program administrator should analyze, compare and evaluate existing voluntary and regulatory offset protocols for project types or sectors most likely to be eligible for inclusion in the U.S. offset program. This analysis should identify key

differences between existing methodologies, as well as areas of scientific uncertainty and elements that could inform the federal offset protocol development process.

- 2) *Increasing relevant federal agencies' technical capacity.* This includes identifying key areas of data deficiency and taking steps to address those deficiencies. It also includes building capacity through staffing and resource development, as well as through coordination with other agencies likely to play a role in the offset market.
- 3) *Convening a scientific advisory committee or committees as soon as possible to assist the offset program administrator in laying the groundwork for the federal regulatory offset program.*
- 4) *Establishing the high-level framework and the process for developing the methodology for potential international sectoral crediting mechanisms including avoided and/or reduced deforestation.*
- 5) *Reviewing the Clean Development Mechanism (CDM) methodologies for potential inclusion in the offset program, both as a potential source of early offsets and as a source of international offset credits once the offset program is implemented.*
- 6) *Fast-track the development of regulations that establish the procedures for submitting and approving offsets.* Establishing the processes for approving offsets, including submission of approval petitions is less technically complex than developing protocols for offset project types and should be undertaken on a separate, faster track to clarify the process for project developers, and remove a potential regulatory hurdle to project approval.
- 7) *Developing the rules for the early action program.* Congress should direct EPA to work as soon as practicable to develop and promulgate the necessary methodologies to provide credit for early actions, including a new program designed to provide incentives for accelerated reductions from industrial sources (see Section E for further explanation).
- 8) *Begin the study mandated in HR2454 Sec. 811(e) as soon as practicable.* HR2454 mandates a study to evaluate the impacts of the cost of the performance standards required in the bill and the ability to achieve compliance with the economy-wide reduction goals given the available supply of offsets. However, the bill currently mandates that this study shall be submitted not later than 18 months *after* the publication of the standards. USCAP recommends that Congress require this cost-benefit analysis be completed before any such standards are in place.

## **D. Assuring an Ample Supply of High Quality Early Offsets**

Existing registry programs and the methodologies they have developed and used must be reviewed and, where appropriate, approved as soon as possible to ensure adequate quantities of early offsets for compliance use. These “early offset projects” should be subject to a commercially-viable and appropriate crediting period that is applied to each project. This will ensure that offset developers and buyers can invest in offsets in

advance of the launch of the national climate program, which will help ensure that a growing supply of offsets will be available in the early years of the program to help contain costs and achieve broad-based environmental benefits.

The following provisions will provide important certainty to early market actors and increase the supply and liquidity in the early offset market, while ensuring that only high-quality offsets are allowed into the regulatory program. They will also provide the offset program administrator valuable experience and information regarding existing emission reduction project methodologies that can be built upon in establishing the regulatory offset program and market. Specifically, USCAP calls for the following provisions:

- 1) *Qualifying early offset methodologies should be approved by the offset program administrator at the earliest possible date.* In Section C above, we have recommended that EPA initiate the review of existing programs and their methodologies immediately (prior to enactment of comprehensive climate legislation) and that Congress takes steps to ensure EPA's resulting criteria are established as valid in final climate legislation. To achieve this, the legislation should provide that any offsets meeting early offset quality criteria established by EPA prior to January 1, 2011 will be eligible for use to meet covered entities compliance obligations. The offset program administrator should complete the evaluation of existing voluntary and regulatory emission reduction and sequestration programs and the methodologies they have utilized against clear and transparent quality criteria. These criteria should ensure that offsets credited represent real, additional, permanent, measurable, and verified emission reductions or increases in sequestration. These steps are needed to ensure a ready supply of high quality offsets on day one of the program.
- 2) *Both domestic and international programs and the methodologies they have utilized should be eligible to generate early offset credits.* Review and approval by the offset program administrator of specific methodologies will ensure that only real, additional, measurable, permanent and verified offset credits from international GHG reduction projects are eligible for use in the U.S. regulatory system. Comprehensive review of existing offset program methodologies for inclusion in the early offset program will help expedite the development of the U.S. federal offset program and will help ensure a ready supply of high quality offset credits early in the program.
- 3) *Crediting periods should be established for early offsets that are long enough to assure investment and deployment.* The crediting period needed to stimulate investment varies by project type, location and circumstance. Assigned, fixed crediting periods that are applied to each offset project should be long enough to assure commercial viability (e.g., approximately 10 years for most project types) though longer periods may be appropriate at the time of offset program administrator approval of the early offset methodology. Offset credits issued before the beginning of the crediting period for early offset supply may be recognized through a dedicated early action set-aside fund described below in Section E.

## E. Recognize and Encourage Early Emission Reductions from Industrial Sources

Many entities in the industrial sector, including those that will eventually be covered by a cap-and-trade system and those that will not be covered by the cap, have already taken actions to reduce emissions from their facilities, and/or have remaining opportunities to reduce emissions before the date on which a cap takes effect. Accordingly, USCAP strongly supports provisions in legislation that: (a) reward real and verifiable early actions that have already been taken by industrial sources; and (b) provide incentives for accelerated emissions reductions at industrial facilities that will be covered by a cap that can be achieved before a cap takes effect.

1) *Credits for Early Action.* USCAP reaffirms its commitment to the importance of credit for early action. In USCAP's *Blueprint for Legislative Action*, we recommended the following two linked elements of policy:

- The federal climate protection program should recognize, encourage, and provide credit for real and verifiable reductions of direct or indirect GHG emissions resulting from actions taken by entities at domestic facilities prior to the enactment of federal legislation, including actions to comply with state and regional GHG cap-and-trade programs.
- Credit for early action should be awarded from within a set-aside of allowances created specifically for the purpose of rewarding early action. Congress should ensure that there is an adequate set aside of allowances under the cap for crediting real and verifiable early action reductions.

USCAP recommends that Congress set aside an adequate number of allowances to reward early action. In particular, credit for early action should be awarded to entities that are able to demonstrate real and verifiable reductions of direct or indirect GHG emissions resulting from actions taken at domestic facilities between a given year (e.g., 1995) and the date of enactment, regardless of whether such entities or facilities will ultimately be regulated under the cap.

2) *Credits for Accelerated Reductions.* USCAP supports the early offset credits included in the House passed bill, with the modifications and additions discussed elsewhere in this document. We recommend that early offsets program include credits for real, verifiable, permanent, and additional reductions in emissions at industrial sources that are achieved between the date of enactment and the date when these sources are directly regulated under the cap (e.g., 2014 for industrial sources in the House passed bill). These credits could specifically be named "credits for accelerated reductions" (CARs) under the early offset program to distinguish them from offsets as they are normally defined (i.e., emissions reductions from entities that are not covered by the cap). As with the rest of the early offset credits, CARs should be treated as the functional equivalent of offsets. As such, in accordance with our *Blueprint for Legislative Action*, CARs should be subject to an overall limit on offsets of

no more than 2 billion tons per year at the outset of the program. In addition, CARs should be fully fungible and tradable in the allowance trading market.

Such credits would provide additional financial incentives—beyond simply reducing an entities' compliance obligation – for entities to initiate emission reduction activities (or to continue reversible ones) prior to being regulated under the cap. These actions must be clearly demonstrated to be additional, real, permanent and verifiable. In order to provide clear and timely incentives for these accelerated reductions, Congress should direct EPA to work as soon as possible to develop and promulgate the necessary procedures and, where necessary, methodologies to implement the CAR concept in concert with the early offsets program envisioned under Section 740 of HR 2454.

3) *Alternatives to an adequate set aside of credits for early action.* Based on available data, it is difficult to determine what set-aside of allowances would be adequate to provide credit for early actions that meet the quality criteria and occurred prior to the date of enactment, as recommended above. This section introduces two possible alternatives to an adequate set-aside in the event that Congress determines it is necessary to consider alternative approaches. Although USCAP members have not reached consensus on these or other alternatives, we believe a discussion of their advantages and disadvantages may be of value to policy makers.

a) *Allowance allocation.* As a substitute for (or supplement to) a set-aside for early action, Congress could ensure that the allocation formula for covered industrial facilities rewards early action. Early actors can be disadvantaged if allowances are freely allocated based on historical emissions in the recent past, because their allocation would be lower than competitors who did not act early to reduce their emissions. To reward early action, allowance allocations to industrial sources could be designed to reflect real and verifiable reductions of direct or indirect GHG emissions resulting from actions taken at domestic facilities after a given benchmark year. For example, firms that can demonstrate that they have undertaken early reduction actions that meet the quality criteria could be allowed to adjust their reported baseline to accurately reflect those early reductions. This approach would only be used to adjust the proportion of allowances that will be freely allocated based on historical emissions.

The advantage of using an allocation approach is that it could directly reward early actors for their voluntary emissions reductions. A potential complication is ensuring compatibility with allocation mechanisms that do not rely on historical baselines – such as the output-based rebates proposed for use in preventing emissions leakage in energy-intensive, trade-exposed industries (EITE). If output-based rebates are used, reward for early action would need to take the form of a separate allocation rather than an adjustment of a formula or baseline.

b) *Including high quality early action reductions from 2005 to the date of enactment – that would have otherwise been eligible to receive credits for early action – under the early*

*offsets program, specifically as credits for accelerated reduction.* An adequate set-aside for credits for early action provides the greatest environmental certainty and is the preferred approach to providing credit for reductions that occurred prior to the date of enactment. As another alternative to an adequate set-aside, emission reductions from industrial facilities that occurred after January 1, 2005 could be treated as CARs and included under the early offset program. Under this alternative, early action would then refer to emissions reductions that occurred before January 1, 2005 (rather than before January 1, 2009 as recommended in Section E.2. above).

This alternative approach has the advantage of avoiding stranded investment in valid reduction projects that occurred during the period of 2005-2009. It has the disadvantage of providing credits that are “above the cap.” Thus, if this approach is used, it should be limited to the relatively small amount of emissions reductions that the USCAP believes have occurred during this period that meet the quality criteria (i.e., they are real, verifiable, permanent, and can be demonstrated to have been additional when they occurred). To ensure that the volume of credits are limited to this relatively small amount, Congress should limit the cumulative amount of such credits to no more than 150-200 million tons with a starting date for “accelerated reductions” of no earlier than January 1, 2005.

## **F. Ensure Coordinated Approach to Offsets and New Source Performance Standards**

There are differing views within the USCAP about whether New Source Performance Standards (NSPS) should be applied to uncapped sectors.

In the event that NSPS for uncapped sectors are promulgated and implemented, USCAP recommends that projects in these sectors approved as a source of early offset credits should be allowed to finish their fixed crediting period for each offset project. This is an important element of providing investor certainty and encouraging deployment of emission reduction technologies as soon as possible.

Furthermore, if NSPS are promulgated and implemented for uncapped sectors, USACAP recommends that such NSPS should not diminish the ability to receive offset credits, nor the magnitude of such credits, prior to 2020.

## **G. Ensure International Offsets are an Integral Part of a High-Quality Offset Supply**

Access to international offsets will be important to ensure both supply and liquidity of offsets in the U.S. system, particularly in the early years of the program. Congress should ensure that the offset program has the flexibility to function effectively while delivering real, additional, permanent, measurable and verified offset credits. To achieve these goals, U.S. climate policy should:

- 1) *Allow a range of offset mechanisms to access international emission reduction opportunities.* Congress should consider allowing four broad categories of international offsets: (a) credits for emissions reductions under approved existing international programs such as the Clean Development Mechanism(CDM); (b) credits issued on a sectoral rather than project-level basis, for designated sectors in major-emitting developing countries; (c) credits for reduced emissions from deforestation and forest degradation (REDD) in tropical forest nations; and (d) project types approved under the U.S. regulatory offset program that have methodologies that are suitable and/or adapted for use internationally.
- 2) *Apply the same set of quality criteria to international offsets as to domestic offsets.* While the approval processes for domestic and international offsets may differ, international offset credits should be subject to the same science-based quality criteria as domestic offsets to address additionality, leakage, impermanence, verification and uncertainty.
- 3) *Ensure that international offset credits are bankable.* Provisions should be included in legislation that make explicit that offsets are “bankable” and eligible for compliance use in the future.
- 4) *Require only one bilateral or multilateral agreement between countries for each type of international offset credit.* Specifically, credits issued under an existing multilateral agreement, such as the agreements under the UN Framework Convention on Climate Change that pertain to the CDM, should not be subject to an additional requirement for a bilateral agreement between countries.
- 5) *Carefully consider the relationship between CDM and sectoral crediting mechanisms.* In the early years of a cap-and-trade program, CDM credits that meet the quality criteria for international offsets should be allowed as a "bridge" mechanism before sectoral crediting takes effect. In sectors and countries that are not designated for sectoral crediting, CDM credits that meet the program’s quality criteria should be allowed. As stated in the *Blueprint for Legislative Action*, Congress should consider specifying a date or dates by which eligibility for international offsets should be contingent upon a host country’s acceptance of a nationally appropriate or sector-specific emissions reduction commitment that covers a suitable share of a country’s emissions, consistent with the global goal of avoiding dangerous climate change.
- 6) *Enhance the likelihood that international REDD activities will play an effective role in emissions reductions, offset markets, and cost containment by:*
  - Building capacity in tropical forest nations with funding provided from appropriations prior to implementation of a U.S. cap-and-trade program and through a set-aside of allowances once the program is in place.
  - Encouraging development of national-level programs in tropical forest nations to establish scientifically-determined baseline rates of deforestation and reduce deforestation below those baselines in a reasonable amount of time. Sub-national

level activities at appropriate scales (e.g., state/provincial level in large-emitting countries, project-level in small countries) should be permitted to build capacity and assist countries in the transition to national accounting.

- Investing in upfront finance to accelerate REDD activities by assuming the risks of and financing the implementation of REDD activities. Such funding could take the form of grants, loans, forward contracts or other financial arrangements, and could be funded through a set-aside of allowances.
- Investing in programs to conserve existing forests, including payments to countries with low forest-related emission rates that are aimed at keeping those rates low. These programs and payments will help counter new and shifting deforestation pressures.