

August 21, 2006

To: Carbon Allocation Task Force Subcommittee
From: Mike Burnett, Executive Director
Subject: Carbon Offsets

The write-up of offsets in the August 15 “Matrix of Outstanding Issue for Carbon Cap” is appropriately general in its nature. And I understand that most of the decisions related to structuring the role that offsets might play would be left to rule making rather than legislation. This is also appropriate, but I am not sure what would be in legislation and what in regulation.

We have had far ranging discussions of offsets in both the full Carbon Allocation Task Force and our Straw Man Subcommittee. Much of this discussion is at the next level of detail, beyond that of the several sentences in the August 15 matrix. Unfortunately, due to time conflicts, I have not been able to attend all of the subcommittee meetings, including those in which offsets were an important agenda item. In addition, due to time constraints within the meetings themselves, it has been difficult to fully explore the complex topic of offsets.

It is not clear to me what the status of our offset discussions are at this next level of detail. As such, I would like to make the views of The Climate Trust on several key offset-related issues known to the subcommittee and the full group. As such, I would like this memorandum to be included in the minutes of our August 21 meeting.

The Climate Trust has significant reservations about a number of the proposals in the May 25 “straw proposal on offset design” prepared by the Center for Clean Air Policy. I will address only very briefly articulate our most significant concerns in this memorandum.

< **Rethink the performance standard approach.** The proposed performance standard is an effective approach for directing financial incentives to the most efficient products along the bell curve of efficiency for a specific technology. Providing such incentives is clearly in society’s interest. However, as described, the approach for determining offset eligibility and quantifying offset benefits is not structured so that it yields real emissions reductions that are essentially the equivalent of reductions by an LSE.

The proposal is that only the top 20th percentile of efficiency would be eligible for treatment as an offset, and that credit would be given only to the extent that 20th percentile is exceeded. In the base year, all of the equipment that comprises this top 20th percentile is already being manufactured and purchased. Now let’s apply the incentive and investigate a few possible outcomes.

First, the most simple example. Let’s say that the manufacturers don’t respond by changing

efficiencies. The same equipment is offered before as before the incentive. In this instance, no incremental emissions benefit has been achieved. Consumers were offered and purchased exactly what they purchased before the financial incentive was applied. Purchasers of the most efficient equipment get rebates. And LSEs get to emit more by using this form of an “offset.” The LSE emissions are not compensated for by the “offset,” and the sum total of LSE emissions and the real emissions reductions from the offset is greater: we break the cap.

Second, let's say that the bell curve shifts by 1% towards greater efficiency. This is generally what is happening economy-wide. Then 21% of the equipment would be eligible. In this instance, not only the initial 20% could be perceived as business-as-usual, but the increase of 1% could be perceived as business-as-usual as well.

Third, if the benchmark is set and the 1%/year background efficiency increase continues for a decade, in the tenth year, 30% of the equipment would be eligible, but there would be no real emissions reductions beyond business-usual.

The conclusion that I draw from these simple examples is that the real emissions reductions are not those computed down to the top 20th percentile benchmark line, but rather those computed by looking at the area of the post-incentive bell curve of efficiencies that exceeds that of the bell curve of efficiencies after the 1%/year background efficiency rate has been applied.

Fourth, if all of the lower 80 percentile equipment ceased to be produced, and was replaced by equipment at the 20th percentile, the proposed approach would yield no emissions reductions for this mitigation, even though clearly there would be reductions in the real world.

Generally, if, in our trading system, we want to deem that “good” behavior is worthy of being awarded a ton of reduction when none or little might be occurring, this is worthy of a lengthy discussion.

If we are going to use a benchmark approach, I'd like to propose an alternative approach, one that relies on a different bell curve. This would be based on the bell curve of purchasing behavior. By far, most efficiency investments are in the 1-2 year payback range, despite this being equivalent to a 50%-100% return on investment. I believe we could establish our benchmarks on a payback basis. If we were to take 3-4-5 year payback that would be unlikely to occur and buy them down to the 1-2 year range, the financial incentive would yield tons that are additional. RGGI is beginning to investigate this approach. This payback based approach could be applied either on a top-down, sector-based perspective, or from a bottom-up, project-based approach. We may in fact want a system that allows for both sector- and project-approaches, and this approach towards determining additionality provides a consistent way to treat both.

Finally, we need a longer and well informed discussion about the bottoms up versus top down

approach towards determining project eligibility. The Climate Trust has been quite effectively applying the bottoms up approach, and I believe that this could be efficiently scaled to likely size of offset needs for Oregon's load based cap and trade system.

- < The suggested "State Incentives Test" for additionality should be eliminated. This test has nothing to do with additionality. In fact, the types of technologies that we want to stimulate are precisely those that would be excellent candidates for BETC and SELP funding. It would make little sense to those looking to fund the introduction of new, lower carbon funding to have to choose between offset funding and BETC/SELP funding. Of course, if BETC/SELP funding is sufficient in and of itself to fund a project, then it would not be additional. Again, I would like to propose a payback approach be used: if, after BETC/SELP, a project still exceeds a payback period that would likely encourage its implementation, then the project would be additional and offset funding could supplement BETC/SELP. RGGI is now investigating such a payback-related approach for integrating other state incentives with offset funds.
- < The "offset life" proposed could be more flexibly defined. Clearly, we need to address dynamic baselines, but there are a number of approaches which could be applied.
- < On the geographic constraint (50% of offsets must come from Oregon), I'd like to point out that RGGI now treats in and out of region offsets the same, and does not have a regional preference, so long as offsets meet their offset requirements.
- < Regarding the financial efficiency of the bottoms up approach, I would like to point out that The Climate Trust has been quite efficient at administering its funds. Over 92% of the money we have spent has gone to offset-related programs, with the rest split between admin and fund raising. In addition, our cost of acquiring offsets has been quite reasonable, when compared with other analogous fund distribution initiatives.

-Environmental commodity brokerage fees are typically about 7% of the transaction value, (compared to the 5% S&C funds provided to the Trust), but their services do not include two of the more costly activities undertaken by the Trust: project evaluation and contract negotiations. Finally, our average cost in percentage terms bears up well in comparison with environmental (non-carbon) fund managers. We have so far incurred costs averaging about 5% of total available funds per year for the two years of each of the selection and contracting processes. This is on the same order of the project acquisition costs of specialty environmental funds, which typically spend around 4% of available funds per year for several years when assembling a portfolio. With our current \$5.5 million acquisition, we will run at 5% for an entire two year process. United Way spends 5% on a one year process to evaluate its fund distribution, which is mostly to follow on recipients.

-We set aside 20% of our offset funding for managing offset contracts. For an offset contract lasting 20 years, this would provide 1%/year for contract management. This

seems reasonable, especially in comparison with the annual fees associated with other fund-based commodities. Stock mutual funds charge around 1.5%/year for management, while bond mutual funds, perhaps the most administratively efficient pooled investment vehicle, charge around 0.5%/year. Specialized environmental investment funds charge 2-4% per year for the ongoing administration of a fund after completing investment.