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International Offsets and U.S. Climate Legislation

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I. Introduction

There are strong drivers supporting the integration of international offsets into U.S. climate legislation, including the dramatic cost savings they promise, and their role in promoting action by other countries. What remains uncertain (beyond the timing of U.S. legislation) are the conditions under which international offsets will be utilized, and any quantitative limits on use. An international offsets program constrained by impossible-to-meet criteria or with mechanics that generate high levels of market uncertainty may not differ significantly from a domestic-only offsets program. For these reasons, there is work left to be done to further educate policy makers about the benefits of international offsets and the necessary elements of a functional international offsets program.

The year 2009 was the first year that a chamber of the U.S. Congress voted in favor of regulating greenhouse gas emissions. In late June, the U.S. House of Representatives passed H.R. 2454, the American Clean Energy Security Act of 2009 (Waxman-Markey), an energy and climate package including an economy-wide cap-and-trade program.

Action then shifted to the Senate, where Senators Barbara Boxer (D-CA) and John Kerry (D-MA) introduced S.1733, the Clean Energy Jobs and American Power Act (Kerry-Boxer). Although their bill passed out of Senator Boxer's Environment and Public Works Committee, it has been roundly criticized by Republicans and moderate Democrats, and has been overshadowed by efforts to create a compromise climate change legislative package led by Senators John Kerry, Lindsey Graham (R-SC), and Joe Lieberman (I-CT). During the final months of 2009 and the beginning of 2010, consideration of climate change legislation in the Senate took a backseat to efforts to pass health care and financial reform legislation. As we write this article, the politics of immigration reform have threatened to arrest development of a comprehensive climate-energy bill in the Senate. As the 2010 midterm elections draw ever nearer, the likelihood that the Senate will take a difficult vote, such as on a climate bill, grows smaller. Nonetheless, efforts to craft a bill that can garner the magical number of Senate votes – sixty are needed to overcome procedural opposition by Republicans – continue, if perhaps not apace. And, in any event, even if legislation does not pass in 2010, the deliberations that occur on international offsets this year will be important be-

cause each new effort in the U.S. Congress has built substantially on previous efforts.

Section II of this article discusses the drivers supporting the integration of international offsets into U.S. greenhouse gas mitigation efforts. Section III provides an overview of the different sources of resistance. Section IV describes the treatment of international offsets in current climate legislation. Section V concludes with a discussion of what to look for as work on climate legislation continues.

II. Factors Favoring Inclusion of International Offsets

A. Cost Savings

The most powerful driver behind inclusion of international offsets in U.S. climate change policies is, by far, the cost savings they can provide. All of the major analyses of U.S. climate legislation project that emission reductions and sequestration achieved in developing countries, primarily involving reductions in tropical deforestation, will be achievable at significantly less cost than most reductions in capped sectors in the United States, and in the near term. The U.S. Environmental Protection Agency's (EPA) analysis of the cap-and-trade program in the Waxman-Markey bill assumes use of over a billion tons of international offsets from the beginning of the program.¹ Without any international offsets, the analysis projects that allowance prices would be 89% higher.²

Unsurprisingly, the capped sectors of the U.S. economy have been strong advocates for offsets, and for international offsets specifically. The United States Climate Action Partnership (USCAP), a coalition of major businesses and environmental NGOs that was very influential during the drafting of the Waxman-Markey bill, has repeatedly called for ample use of domestic and international offsets to provide cost

¹ Environmental Protection Agency, EPA Analysis of the American Clean Energy and Security Act of 2009 H.R. 2454 in the 111th Congress, June 23, 2009, at 38.

² Id. at 3.

containment.³ In November of 2009, a group of eighteen major employers wrote to the Senate urging the chamber to incorporate a robust role for international offsets in climate legislation to protect U.S. jobs.⁴

B. Environmental and social co-benefits

In addition to cost savings, international offsets offer a variety of environmental and social co-benefits. These benefits are a second major driver supporting international offsets in the context of U.S. climate legislation. REDD projects – projects for Reducing Emissions from Deforestation and Forest Degradation – generate the most political capital, as they offer a means to channel significant private sector funding into preserving the world's tropical rainforests and all the biodiversity and ecosystem services they provide. Other offset project types also yield environmental co-benefits by reducing non-greenhouse gas pollutants and increasing habitat area. International offset projects could also generate a sustainable income source for local communities.

C. Promoting Mitigation Commitments from Developing Countries

The third major driver for international offsets is the role they play in international diplomatic negotiations around climate change. In the Copenhagen Accord, developed countries committed to “provide adequate, predictable and sustainable financial resources, technology and capacity-building to support the implementation of adaptation action in developing countries.”⁵ International offsets offer a way to funnel private sector capital into developing countries. Using offsets to raise capital is far less politically-sensitive than asking the Appropriations Committees of Congress to send U.S. taxpayer money overseas.

³ United States Climate Action Partnership, A Blueprint for Legislative Action: Consensus Recommendations for U.S. Climate Protection Legislation, Jan. 2009, p. 8-11; United States Climate Action Partnership, A Call to Action, Jan. 2007, p. 8; United States Climate Action Partnership, USCAP Recommendations and Options on Offset Quality, Early Supply and Early Emission Reductions from Industrial Sources, Dec. 14, 2009. These letters and a list of USCAP members are available at www.us-cap.org.

⁴ The letter, which was sent on November 10, 2009, was coordinated by the U.S. Coalition for Emission Reduction Projects and addressed to Senators John Kerry, Lindsey Graham, and Joe Lieberman, leaders of the current effort to craft a compromise climate package in the Senate. Signatories included Alpha Natural Resources, American Electric Power, DTE Energy, Dominion, The Dow Chemical Company, Duke Energy, DuPont, El Paso Corporation, Exelon, Southern Company, FPL Group, Intel, International Paper Company, NRG Energy, National Grid, PG&E Corporation, PNM Resources, and Rio Tinto. The letter is available at www.uscerp.com.

⁵ Copenhagen Accord, available at http://unfccc.int/files/meetings/cop_15/application/pdf/cop15_cph_auv.pdf.

III. International Offsets Skepticism in the United States

Notwithstanding their significant benefits, there is significant resistance to international offsets among members of Congress. This reluctance is both multifaceted and to some extent, nebulous – it has not solidified into a well-organized opposition, perhaps because it does not follow either party lines or traditional lobbying coalitions. Yet, it has marked the current legislative proposals.

One area of skepticism focuses on the transfer of money (and jobs) to other countries (especially, of course, to China). Another variation on this theme posits that international offsets will be too cheap, undercutting the market (or at least the premium price paid) for domestic offsets and domestic natural gas.

A different type of economic concern about international offsets holds that the cost savings from such offsets are overstated. There is a growing chorus of voices that says that the EPA and others have relied on unrealistic assumptions about the available supply of international offsets.

The environmental concerns with international offsets fall into two categories. First, many environmentalists, and their advocates in the Congress, do not have faith in the integrity of the Clean Development Mechanism, and are quick to observe that the United States has no say in the operations of the CDM.

Another environmental objection to international offsets is the concern that offsets will be, in a sense, too effective in reducing allowance prices, thereby significantly reducing or eliminating the need for domestic emission reductions by capped sectors. Environmentalists and others worry that this will diminish the demand for (and thus investment in) the development of low-carbon technologies that will be needed to achieve future reductions.

IV. Treatment of International Offsets in Recent Legislative Proposals

Both the drivers for international offsets and concerns about them are clearly reflected in existing climate legislation, with a number of examples discussed below. Of course, existing legislation may not be making its way to President Obama's desk anytime this side of the mid-term elections in November. Nonetheless, U.S. climate legislative proposals tend to lean heavily on efforts from prior Congresses, and the Waxman-Markey bill is noteworthy as the most fully developed cap-and-trade program to date and as the first to be passed by a house of Congress. Even if a climate bill is not passed this year, these elements are likely to reappear.

A. Quantitative Limits

Both the Waxman-Markey and Kerry-Boxer bills impose

limits on the number of offsets that may be used to comply with the U.S. cap, with the goal of restricting offset use to a maximum of two billion tons annually. The limit imposed by the Kerry-Boxer bill is particularly problematic. It allows capped entities to submit a quantity of offset credits that is proportional to that entity's share of covered emissions.⁶ Only a quarter of the offsets an entity may submit can be international offsets.⁷ This percentage can be increased to allow additional use of up to 750 million tons of international offsets, but that is only done if the number of domestic offsets available at or below allowance prices in a given year is likely to be less than 900 million tons.⁸

This outcome is an example of how a successful political compromise can create an unworkable policy outcome. The supply of international offsets obviously cannot be turned on or off like a spigot as envisioned by the Kerry-Boxer provisions. If the international offsets market is not given a reliable signal of future U.S. demand, it will be difficult to attract capital to develop projects. If U.S. policy makers can be made more familiar with the importance of investment certainty to generating offset supply, presumably a means can be found to favor domestic offsets while still providing a more predictable long-term signal of U.S. demand for international offsets.

B. Penalty on Use of Offsets

Both the Waxman-Markey and Kerry-Boxer bills would require capped entities to submit five international offset credits in lieu of four emission allowances beginning in 2018.⁹ The penalty provision could be seen as achieving a number of aims – generating additional emission reductions, discounting the value of international offsets on the assumption that they are not fully additional and real, and/or increasing the value of domestic offset credits.

These provisions again call for an effort to educate policy makers. Any uncertainties about the integrity of an offset project should rightly be accounted for through the application of conservative baselines and discounts in the context of a project-type-specific methodology. Different types of offset projects have different degrees and sources of uncertainty. It is inefficient, and therefore expensive, to impose this type of across-the-board discount on all international offsets.

C. Host Country Agreement

Both Waxman-Markey and Kerry-Boxer require that the United States and the host country of an international offset

project be party to a bilateral or multilateral agreement that ensures that the requirements for international offsets are met and provides for the distribution of offset credits.¹⁰ After consulting with the Department of State, the EPA, and outside experts, the Congressional Budget Office concluded that negotiating such host country agreements would take significant time.¹¹ The requirement could severely constrain international offset supply during the early years of a U.S. cap-and-trade program.

In order to prevent the host country agreement from delaying the availability of at least those international offsets that come through the CDM, it would be useful to convince policy makers that a workable alternative would be to have the EPA enter into an umbrella agreement with the CDM Executive Board. Under the current legislative proposals, the EPA has an oversight role for all international offsets in any event. An EPA-CDM agreement would be an equally effective, and more efficient approach to providing the necessary assurances than an approach in which the United States enters into bilateral agreements with each host country.

D. Projects vs. Sectors

Both the Waxman-Markey and the Kerry-Boxer bills incorporate a strong emphasis on shifting from project-level offsets to sector-based emission reductions trading for countries that are major economies.

The sectoral crediting requirements reflect different but mutually reinforcing concerns. One goal of these provisions is to prevent leakage – the shifting of emissions from the location of an offset project to a different location in the same sector of that country. This is one means of ensuring the environmental integrity of emission reductions. At the same time, by encouraging the adoption of sectoral emission baselines, the supporters of these provisions hope to reduce competitiveness impacts on U.S. industry – and to reduce any incentive for capped industries to move to countries without emission caps. Sectoral policies are also seen as a way to transition developing countries towards adopting emission limits.

The relevant provisions would require the EPA and the State Department to identify developing countries and specific sectors for which it is appropriate to credit emission reductions against a sector-wide baseline rather than as individual stand-alone projects.¹² Sector-based crediting is to be used for sectors and countries with comparatively high greenhouse gas emissions, comparatively greater levels of

⁶ Clean Energy Jobs and American Power Act, S. 1733, 111th Cong. Division B, §101, proposed Clean Air Act § 722(d)(1)(B) (hereinafter CEJAP).

⁷ *Id.* at § 722(d)(1)(B)(iii).

⁸ *Id.* at § 722(d)(1)(C).

⁹ ACES at § 722(d)(1)(A, D); CEJAP at § 722(d)(1)(A)(i), (D).

¹⁰ ACES at § 743(b)(2); CEJAP at § 744(b)(2)(C).

¹¹ Congressional Budget Office, Cost Estimate of H.R. 2454, American Clean Energy and Security Act of 2009, June 5, 2009, at 16.

¹² ACES at § 743(c); CEJAP at § 744(c).

economic development, and/or for sectors that would be capped in the United States. For such sectors, offset projects would be credited against a “domestically enforceable baseline level of absolute emissions established in a country-specific agreement.”¹³ The baseline would be below a projected business-as-usual pathway.

However, both bills also provide that, starting in 2016, regulated entities in the United States could no longer use Certified Emission Reductions from projects in sectors and countries identified as appropriate for sectoral crediting.¹⁴ This deadline appears to be motivated by a theory that the promise of income for CDM projects will cause developing countries to drag their feet in negotiating sectoral limits. Regardless of whether this is true, even if countries were negotiating in good faith, it is highly unlikely that sectoral trading programs could be operational by 2016.

Requiring a phase-out of CERs before sectoral programs can be operational will simply shrink the quantity of international offsets available to the U.S. market. It will take a number of years to designate the appropriate sectors, negotiate sectoral baselines, and implement a framework to credit projects against the baselines. Phasing out CERs from the designated sectors in 2016 would therefore unnecessarily disrupt the supply of international offsets – something U.S. policy makers may not yet fully appreciate.

E. REDD

Both the Waxman-Markey and Kerry-Boxer bills have extensive and detailed REDD provisions.¹⁵ Under the framework they establish, countries with more than 1% of global greenhouse gas emissions or more than 3% of global forest-sector and land use change emissions must establish national deforestation baselines. Each baseline must reflect historical deforestation data and establish a trajectory that results in zero net deforestation within twenty years of its establishment. Offset credits will only be issued for emission reductions measured against the national baseline. Only nations with the technical capacity to measure and monitor deforestation emissions, the institutional capacity to reduce deforestation emissions, and a land use plan that assesses deforestation drivers and identifies reforms needed to address them will be eligible for participation.

States and provinces within developing countries may be eligible to establish a state- or province-wide baseline against which REDD emission reductions will be credited for up to five years. Subsequently, the country must establish a national deforestation baseline to receive REDD offset credits.

¹³ ACES at § 743(c)(3)(A).

¹⁴ ACES at § 743(d)(1); CEJAP at § 744(d)(1).

¹⁵ ACES § 743(e); CEJAP § 744(e).

Developing countries with less than 1% of global greenhouse gas emissions and less than 3% of global forest-sector and land use change emissions will be eligible to generate REDD offset credits measured against a project-level baseline for five years, after which point a national deforestation baseline will be required. The phase-out may be extended for up to eight years for least developed nations if they lack the capacity to implement a national baseline.¹⁶

In addition to the baseline requirements, all REDD projects must (1) adhere to sustainable forest management practices; (2) promote or restore native forest species and ecosystems where practicable; (3) incorporate full participation of local communities, indigenous peoples, and forest-dependent communities in affected areas as partners and primary stakeholders during all stages of project design and implementation; (4) provide equitable sharing of profits and benefits from offset credits with local communities, indigenous peoples, and forest-dependent communities.

The environmental and social justice considerations that animate these provisions are clear and laudable. However, they raise at least two sets of issues for the marketplace. First, the Day One requirement for national baselines in major deforestation countries (such as Brazil) implies that a project developer or investor would need assurances from the host government that its project will be credited within national baseline, irrespective of deforestation emission increases elsewhere in the country.

Second, it likely will be challenging for many projects to meet all of the social and environmental requirements, including sharing of profits with local communities. If only a small number of projects could conform to these requirements, it is not clear whether the REDD program established by these provisions would effectuate its goals of driving private sector funding into tropical forest preservation and generating low-cost emission reductions.

Third, it also seems likely that many countries will lack the capacity to establish national deforestation baselines in the near term, which will make those countries ineligible for offset funding and reduce the available supply of international offset credits during the early years of the cap-and-trade program.

V. What to Watch

There is room for improvement in the international offset provisions of existing U.S. cap-and-trade legislation. The

¹⁶ Under Kerry-Boxer, the initial time period is eight years after the first covered entity compliance deadline, with the possibility of a five year extension. CEJAP at § 744(e)(6)(D).

current legislative traffic jam in the U.S. Congress – though it may delay serious consideration of climate legislation – may also provide time to educate policy makers about the necessary components of a practical and effective international offsets program, and the unintended consequences likely to follow implementation of certain provisions in the Waxman-Markey and Kerry-Boxer bills.

Efforts to create a compromise climate legislative package will likely continue in the Senate under the leadership of Senators Kerry, and Lieberman, and hopefully Senator Graham. Even if a bill does not pass in 2010, their work will very likely serve as the template for subsequent legislation. Convincing the Senate to make a relatively small number of strategic changes to the proposed international offset provisions could make significant progress towards meeting the goal of creating a highly functional international offsets program capable of achieving its environmental and cost containment purposes.

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is a law firm with one of the world's largest and most diversified climate change practices. Market surveys in Environmental Finance magazine have regularly rated the firm as a leader in both the compliance and voluntary carbon markets. Among the firm's clients is the Coalition for Emission Reduction Projects, a coalition dedicated to educating the public about the benefits of allowing regulated entities to use credits from domestic and international offset projects in GHG regulatory programs.