

Inside Cal/EPA

An exclusive weekly report on environmental legislation, regulation and litigation from the publishers of Inside EPA

Vol. 21, No. 9 — March 5, 2010

Slowing Investment In GHG-Offset Projects Heightens Pressure On ARB

Carbon-offset development and trading companies say the air board's rescission last week of four standards, or protocols, for designing such offset projects has already prompted a significant decline in investments by U.S. and foreign firms. The purported slide in offset-project investments -- also being driven in large part by Congress' continued struggles to pass a cap-and-trade bill -- is prompting the industry to urge the board to quickly review and readopt the protocols.

The controversy in California over greenhouse gas (GHG) offsets is significant because the four protocols withdrawn by the board were drafted by the Climate Action Reserve (CAR), whose standards are being followed by 65% of the voluntary offset projects in the U.S., according to a market report released earlier this week.

The Air Resources Board Feb. 25 voted to withdraw its adoption of the four CAR GHG-offset protocols, in large part because environmentalists had threatened to sue the board over a forestry-related protocol because it had not undergone California Environmental Quality Act (CEQA) review (*see Feb. 19 issue*). ARB decided to withdraw the other three because these had also not gone through the CEQA review process. The protocols are: CAR's forestry version 2.1; manure digester version 2.1; urban forest version 1.0; and forestry version 3.0.

ARB says it will conduct the proper CEQA reviews of the protocols, make any changes that may be necessary, and readopt them later this year. The protocols would then be acceptable for use under California's mandatory cap-and-trade program, which is scheduled to launch in 2012. The program is also expected to link to the Western Climate Initiative (WCI), a regional cap-and-trade program that includes three major Canadian provinces.

ARB withdrawal of the offset protocols was criticized by the GHG-offset industry, including major firms such as Morgan Stanley Capital Group, Inc., TerraPass Inc., and the Carbon Offset Providers Coalition (COPC), which had urged the board to decline to withdraw the protocols, and instead substitute the questionable standards with more updated versions that have been adopted by CAR in recent weeks.

"Why leave us -- project developers, investors, the market as a whole and the people of the state -- with *norecognized* offset protocols?" COPC asked ARB in a Feb. 24 letter. "In the absence of a fully developed program of ARB-generated protocols, declining to adopt existing, rigorous and thoroughly vetted voluntary protocols will undermine the development of a robust offsets program for the compliance market in a timely manner. And there is not much time before the January 1, 2012 roll-out of the state's cap-and-trade program." *A copy of the letter is available at InsideEPA.com.*

Withdrawing support for the voluntary protocols "in the absence of ARB-generated compliance protocols will send a bad signal to the market," COPC adds. "Uncertainty with regard to qualifying standards will stifle investment in this sector, which is a crucial part of the green economy."

Morgan Stanley states in a Feb. 24 letter to ARB that the withdrawal of the protocols "will create great uncertainty in the market and tacitly discourage parties from continuing to pursue early action." Current market participants "will have no certainty whether the offsets that presently exist in the market will count as early action under California's GHG emissions reduction programs, and thus will have great trepidation regarding whether or not to continue to participate in the market at all in the absence of any stable rules. This result would frustrate the end goals of AB 32, which ultimately seeks to reduce GHG emissions." *A copy of the letter is available at InsideEPA.com.*

A source with San Francisco-based TerraPass said the ARB action -- as well as Congress' failure to move a cap-and-trade bill -- appears to have contributed to several major worldwide corporations declining within the past few

weeks to invest in some of the company's proposed offset projects in the West that adhere to the CAR protocols. The source said that ARB's announcement to not begin the CEQA-review process for the withdrawn protocols until April is even more disheartening for the industry, because project types that will be acceptable under the state's cap-and-trade program will still be unknown in the following months.

On this point, Morgan Stanley argues that by restarting the process with an April workshop, ARB "will inject somewhere between several months to perhaps, at the outside, two years worth of uncertainty among project developers," the company's letter states. "This extended period of discontinuity during rule development runs the real risk of losing a significant portion of the potential projects that would otherwise be developed. This result, in turn, would mean losing a significant degree of beneficial early action activity."

The uncertainty over the California governor's race is also worrying GHG-offset industry representatives -- with Republican candidates promising they will suspend all AB 32 regulations for at least a year, the TerraPass source said. "When you look at all of those things together -- a lot of these corporations we're dealing with are not speculators, they're prudent investors, and they're starting to think about whether these look like prudent investments -- and now they're preferring to take a wait-and-see approach."

An offset-market source added that while investment in voluntary GHG-offset projects "is always a gamble" in terms of whether those reductions will be recognized under a mandatory regulatory program, scores of companies have been operating under the assumption that because ARB had adopted the CAR protocols over the past several years, the board was very likely to recognize them as early reductions under the cap-and-trade program.

A new analysis of the voluntary GHG-offset market by the market services firm Point Carbon cited in recent published reports shows that the price for offset credits has sharply declined in the past year, in part because of the failure of Congress to pass a climate bill. ARB's withdrawal of the CAR protocols may in the short term contribute to a continuing decline both in the price of offset credits and investment in offset projects, the analysis indicates, because about 65% of U.S. offsets follow the CAR protocols.

ARB Chairwoman Mary Nichols at the Feb. 25 ARB meeting attempted to assuage some of the concerns raised by the GHG offset providers and traders by saying that the protocols would be readopted in a reasonable time frame, but made a fuzzy and seemingly ambiguous comment about whether offset projects that have followed the CAR protocols ultimately would be credited under ARB's mandatory program.

"Our only concern now is, as we move into a cap-and-trade program, is the need to maintain an arms-length relationship with the CAR or any other organization that would come forward and start to try to do the same thing in terms of developing the kind of high-quality offsets we need . . ." she said at the meeting. "And we have every expectation that as we move forward into the mandatory cap-and-trade program that the offsets that have been created pursuant to the protocols we approve are going to be accepted for compliance purposes by and large."

Copyright 2010 Inside Washington Publishers. Reprinted with Permission