

# International Offsets and U.S. Climate Legislation

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The United States has a complicated relationship with international offsets. During the Kyoto Protocol negotiations, the United States was a forceful advocate for integrating offsets into the international regime—ensuring that market-based mechanisms and an international trade in emission reductions became a part of the Kyoto framework.

Yet, like the Kyoto Protocol, the fate of international offsets in the context of American climate change mitigation efforts rests with the U.S. Congress. There are strong drivers supporting the integration of international offsets into U.S. climate legislation; there are also factions unknowledgeable about and deeply uncomfortable with international offsets.

The outcome of the tug-of-war between international offset advocates and detractors in Congress is not greatly in doubt. Any U.S. climate change legislation is likely to incorporate international offsets because of 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. An international offsets program hamstrung with criteria that are impossible to meet or mechanics that generate high levels of market uncertainty may not differ significantly from a domestic-only offsets program.

As such, there is work left to be done to educate policymakers further about the benefits of international offsets and the necessary elements of a functional international offsets program.

In late June 2009, the U.S. House of Representatives passed H.R. 2454, the American Clean Energy Security Act of 2009 (the Waxman-Markey Bill), an energy and climate package including an economywide cap-and-trade program. This marked the first time a chamber of Congress voted in favor of regulating greenhouse gas (GHG) emissions. The legislative focus then switched to the U.S. Senate, where Sens. Barbara Boxer (D-Cal.) and John Kerry (D-Mass.) introduced S. 1733, the Clean Energy Jobs and American Power Act (the Kerry-Boxer Bill). This bill, although passed out of Senator Boxer's Environment and Public Works Committee, has been roundly criticized by Republicans and mod-

erate Democrats, and has been overshadowed by efforts to create a compromise climate change legislative package led by Sens. Kerry, Lindsey Graham (R-S.C.), and Joe Lieberman (I-Conn.). The three senators have worked for months to garner significant industry support and hope to find 60 senators to support their bill, which will allow them to overcome procedural opposition by Republicans.

During the final months of 2009, consideration of climate change legislation in the Senate took a backseat to efforts to pass health care legislation and financial reform legislation. The congressional Democratic leadership recently signaled that climate legislation may also be superseded by immigration reform, which precipitated Senator Graham's abrupt and public departure<sup>1</sup> from efforts to garner support for the Kerry-Graham-Lieberman Bill—casting those efforts into disarray. Even if Senator Graham comes back on board, the approaching 2010 mid-term elections could diminish the likelihood that the Senate will take a difficult vote, such as on a climate bill.

Nonetheless, efforts to craft a bill that can garner the magical number of Senate votes continue, if perhaps not apace. Even if a climate bill does not pass in 2010, these efforts, and the legislation they produce, are likely to serve as the foundation of future climate change legislation.

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

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*Authors' Note: The views expressed in this Article do not necessarily represent the views of Van Ness Feldman, P.C., or its clients.*

1. Senator Graham has been one of the few Republicans who will cross the aisle to work with the Democrats on climate change and on immigration reform. He has claimed that the sudden focus on immigration reform is a political maneuver to mobilize the Democratic base, and that it will doom efforts to find room for climate legislation on an already crowded Senate legislative calendar. Sheryl G. Stolberg, *The White House's G.O.P. Mainstay? Maybe Not*, N.Y. TIMES, Apr. 26, 2010, at A13.

## I. Drivers for Inclusion of International Offsets

There are three primary drivers supporting the inclusion of international offsets in U.S. climate legislation: cost savings; environmental co-benefits; and international diplomacy.

### A. Cost

The cost savings that international offsets are projected to provide are by far the most powerful driver behind international offsets. 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. The U.S. Environmental Protection Agency's (EPA's) analysis of the cap-and-trade program in the Waxman-Markey Bill assumes use of over one billion tons of international offsets from the beginning of the program.<sup>2</sup> Without any international offsets, the analysis projects that allowance prices would be 89% higher.<sup>3</sup> Similarly, the Congressional Budget Office's (CBO's) analysis of Waxman-Markey projected that annual savings from offsets could be about 70%.<sup>4</sup>

Central to these modeled cost savings is the potential to implement international offset projects in the near term. It will take time for carbon-saving technologies and infrastructure to be developed and installed in the capped sectors of the economy. International offsets are projected to reduce costs by serving as a bridge to a time when low-carbon technologies are more numerous, less expensive, and more widely commercially available.

Unsurprisingly, the capped sectors of the U.S. economy have been strong advocates for offsets, and for international offsets specifically. The U.S. Climate Action Partnership (USCAP), a coalition of major businesses and environmental nongovernmental organizations 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 containment.<sup>5</sup> In November 2009, a group of 18 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.<sup>6</sup>

### B. Environmental Co-Benefits

The second major driver supporting international offsets in the context of U.S. climate legislation are the environmental (and social) co-benefits associated with many offset projects. Reducing Emissions From Deforestation and Forest Degradation (REDD) projects 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-GHG pollutants and increasing habitat area. International offset projects could also generate a sustainable income source for local communities.

### C. Diplomacy

The third major driver for international offsets is the role they play in international diplomatic negotiations around climate change. Developing countries have demanded that industrialized nations provide significant financial resources to support adaptation and mitigation efforts. 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."<sup>7</sup> International offsets offer a way to funnel significant 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 taxpayer money overseas.

## II. Resistance to Reliance on International Offsets

Despite the benefits that international offsets offer in terms of cost savings, flexibility in the timing of capped-sector reductions, environmental co-benefits, and international diplomacy, there is significant resistance to their use among some members of Congress. This reluctance is both multifac-

2. OFFICE OF ATMOSPHERIC PROGRAMS, U.S. EPA, EPA ANALYSIS OF THE AMERICAN CLEAN ENERGY AND SECURITY ACT OF 2009: H.R. 2454 IN THE 111TH CONGRESS 38 (2009), available at [http://www.epa.gov/climatechange/economics/pdfs/HR2454\\_Analysis.pdf](http://www.epa.gov/climatechange/economics/pdfs/HR2454_Analysis.pdf).

3. *Id.* at 3.

4. NATALIE TAWIL, CBO, THE USE OF OFFSETS TO REDUCE GREENHOUSE GASES 8 (2009), available at <http://www.cbo.gov/ftpdocs/104xx/doc10497/08-03-Offsets.pdf>.

5. See USCAP, A BLUEPRINT FOR LEGISLATIVE ACTION: CONSENSUS RECOMMENDATIONS FOR U.S. CLIMATE PROTECTION LEGISLATION 8-11 (2009), available at [http://www.us-cap.org/pdf/USCAP\\_Blueprint.pdf](http://www.us-cap.org/pdf/USCAP_Blueprint.pdf); USCAP, A CALL FOR ACTION 8 (2007), available at <http://us-cap.org/USCAPCallForAction.pdf>.

6. Letter from Alpha Natural Resources et al. to Sen. John Kerry et al. (Nov. 10, 2009), available at <http://www.uscerp.com/assets/attachments/Letter%20on%20the%20importance%20of%20international%20offsets%20from%20U.S.%20industry.pdf>. The letter was coordinated by the U.S. Coalition for Emission Reduction Projects and addressed to Senators Graham, Kerry, and 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, 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.

7. U.N. Framework Convention on Climate Change, Draft Decision, CP. 15, Copenhagen Accord (Dec. 18, 2009), available at [http://unfccc.int/files/meetings/cop\\_15/application/pdf/cop15\\_cph\\_auv.pdf](http://unfccc.int/files/meetings/cop_15/application/pdf/cop15_cph_auv.pdf).

eted 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.

Criticisms of international offsets raised by members of Congress can be grouped into three rough categories: economic; environmental; and functional.

### A. Economic

One group of international offset critics takes issue with 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. The U.S. agriculture sector hopes that domestic offsets will provide farmers with an additional lucrative income stream, and farm interests are a powerful force on Capitol Hill.

### B. Environmental

Environmentalists, and their advocates in Congress, are concerned that the incorporation of international offsets into a U.S. climate program will significantly reduce or eliminate the need for domestic emission reductions by capped sectors. Some environmental groups are opposed to this result; because they believe that U.S. industry has a kind of moral obligation to reduce emissions at their own facilities. Others worry that the availability of international offsets will diminish the demand for (and thus investment in) the development of low-carbon technologies that will be needed for domestic emission reductions in capped sectors under an increasingly stringent emissions cap. The opposition of the mainstream environmentalist lobby to international offsets has been curbed somewhat, however, by their support for REDD offsets as a means of addressing tropical deforestation.

### C. Functional

The third category of critics is concerned that a substantial quantity of international offsets will not represent real, additional emission reductions. The Clean Development Mechanism (CDM) has been frequently—if not particularly knowledgeably or fairly—maligned in congressional hearings on offsets. Many members of Congress (and the environmental community) are understandably hesitant about relying upon an institution over which they exercise no control, and which has experienced some well-publicized difficulties, to ensure the integrity of international offsets. Some parties, both on and off Capitol Hill, question whether the CDM, given its track record, could possibly process the quantity of offsets projected to be purchased by the United States, and whether speed of processing and environmental integrity can be mutually compatible.<sup>8</sup>

8. See, e.g., Michael Wara & David G. Victor, *A Realistic Policy on International Carbon Offsets* (Program on Energy and Sustainable Dev., Working

## III. Current Legislative Treatment of International Offsets

Both the drivers for international offsets and concerns about them are clearly reflected in existing climate legislation, with a number of examples discussed below. Even if a climate bill is not passed this year, these elements are likely to reappear.

### A. Limits on Offset Use

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 of carbon dioxide equivalent (CO<sub>2</sub>e) reductions or sequestration annually. The Waxman-Markey Bill allows capped entities to use offsets to meet only a percentage of their compliance obligation, beginning at approximately 29% in the 2012-2020 period and rising to 36% by 2030.<sup>9</sup> Only one-half of this percentage may be composed of international offsets, unless the availability of domestic offsets at or below allowance prices is projected to be less than 900 million tons. Under those conditions, the international offsets usage formula is adjusted upward, allowing up to 1.5 billion tons of international offsets to be used.<sup>10</sup>

The limit imposed by the Kerry-Boxer Bill is slightly different. It allows capped entities to submit a quantity of offset credits that is proportional to that entity's share of covered emissions.<sup>11</sup> Only one-quarter of the offsets an entity may submit can be international offsets.<sup>12</sup> 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.<sup>13</sup>

These limits on offset use are in reality quite generous when compared against projected utilization. This outcome should be seen as an expression of the dynamic between offset advocates and skeptics in Congress: (1) there is a need to limit offset use, but not at the expense of cost containment; and (2) domestic offsets are favored above international offsets.

This outcome is also 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. policymakers can be made more familiar with the importance of investment certainty to generating offset supply, presumably a means can be found to

Paper No. 74, 2008), available at <http://www.law.stanford.edu/publications/details/4032/>.

9. American Clean Energy and Security Act of 2009, H.R. 2454, 111th Cong. §311 (2009) (proposed Clean Air Act (CAA) §722(d)(1)(B)).  
 10. H.R. 2454 §311 (proposed CAA §722(d)(1)(B)-(C)).  
 11. Clean Energy Jobs and American Power Act, S. 1733, 111th Cong. div. B, §101 (2009) (proposed CAA §722(d)(1)(B)).  
 12. S. 1733 div. B, §101 (proposed CAA §722(d)(1)(B)(iii)).  
 13. S. 1733 div. B, §101 (proposed CAA §722(d)(1)(C)).

favor domestic offsets while still providing a more predictable long-term signal of U.S. demand for international offsets.

### B. Discount

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.<sup>14</sup> The discount 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.

To whatever degree this discount is justified by citing concerns with the legitimacy of international offset credits, these provisions again call for an effort to educate policymakers. 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.

To whatever degree the discount is justified by reference to the additional emission reductions it will generate or to the value it will add to domestic offset projects, the same point should be made—a discount on international offsets is a distortion of the market, and comes at a cost. That cost will be borne by American families and businesses.

### 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.<sup>15</sup> The Kerry-Boxer provisions also require that the offset project developer be eligible to receive service of process in the United States for any action filed in federal courts.<sup>16</sup>

After consulting with the U.S. Department of State (DOS), EPA, and outside experts, the CBO concluded that negotiating such host country agreements would take significant time.<sup>17</sup> The requirement could severely constrain international offset supply during the early years of a U.S. cap-and-trade program.

It is not entirely clear what forces are behind these provisions, other than perhaps a general concern about the enforceability of U.S. requirements in the context of international offset projects. 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 policymakers that a workable alternative would be to have EPA enter into an umbrella agreement with the CDM Executive Board. Under the current legislative proposals, 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 entered into bilateral agreements with each host country.

### D. Projects Versus 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. Crediting emission reductions against a sectorwide emissions baseline is one means of ensuring the environmental integrity of emission reductions. At the same time, by encouraging the adoption of sectoral 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 toward adopting emission limits.

The sectoral-crediting provisions in the Waxman-Markey and Kerry-Boxer Bills would require EPA and the DOS to identify developing countries and specific sectors for which it is appropriate to credit emission reductions against a sectorwide baseline, rather than against individual, stand-alone projects.<sup>18</sup> Sector-based crediting is to be used for sectors and countries with comparatively high GHG emissions, comparatively greater levels of 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.”<sup>19</sup> 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 (CERs—credits earned through the CDM) from projects in sectors and countries identified as appropriate for sectoral-crediting.<sup>20</sup> 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

14. H.R. 2454 §311 (proposed CAA §722(d)(1)(A), (D)); S. 1733 div. B, §101 (proposed CAA §722(d)(1)(A)(ii), (D)).

15. H.R. 2454 §311 (proposed CAA §743(b)(2)); S. 1733 div. B, §101 (proposed CAA §744(b)(2)).

16. S. 1733 div. B, §101 (proposed CAA §744(b)(2)(C)(iii)).

17. CBO, COST ESTIMATE: H.R. 2454, at 16 (2009), available at <http://www.cbo.gov/ftpdocs/102xx/doc10262/hr2454.pdf>.

18. See H.R. 2454 §311 (proposed CAA §743(c)); S. 1733 div. B, §101 (proposed CAA §744(c)).

19. H.R. 2454 §311 (proposed CAA §743(c)(3)(A)).

20. H.R. 2454 §311 (proposed CAA §743(d)(1)); S. 1733 div. B, §101 (proposed CAA §744(d)(1)).

operational by 2016. 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 shrink the quantity of international offsets available to the U.S. market—something U.S. policymakers may not yet fully appreciate.

## E. REDD

The REDD provisions in Waxman-Markey and Kerry-Boxer are extensive and detailed.<sup>21</sup> Under the framework they establish, countries with more than 1% of global GHG emissions or more than 3% of global forest-sector and land use change emissions must establish national deforestation baselines.<sup>22</sup> Each baseline must reflect historical deforestation data and establish a trajectory that results in zero net deforestation within 20 years of its establishment.<sup>23</sup> 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.<sup>24</sup>

States and provinces within developing countries that are independently major emitters of GHGs may be designated as eligible to establish a statewide or provincewide baseline, and REDD emission reductions will be credited against this baseline for up to five years after the first year for which a covered entity must comply with the cap.<sup>25</sup> Subsequently, the country must establish a national deforestation baseline to receive REDD offset credits.

Developing countries with less than 1% of global GHG 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.<sup>26</sup> The phaseout may be extended for up to eight years for the least developed nations if they lack the capacity to implement a national baseline.<sup>27</sup>

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; and (4) provide equitable sharing of profits and benefits from offset credits with local communities, indigenous peoples, and forest-dependent communities.<sup>28</sup>

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.

Both bills dedicate a substantial number of emission allowances (and thereby, funding) to a program to reduce tropical deforestation, both through emission-reducing activities and capacity-building.<sup>29</sup> This funding should help countries with high deforestation emissions to develop national baselines, measurement capabilities, and land-sector plans. It will take time, nonetheless—and under the existing provisions, offset projects hoping to sell to the U.S. market will not be developed during this time. This could deny private-sector funding to these areas and reduce the supply of international offsets to the U.S. market.

## IV. What to Watch

There is room for improvement in the international offset provisions of existing U.S. cap-and-trade legislation. The current legislative traffic jam in Congress—though it may delay serious consideration of climate legislation—may also provide time to educate policymakers 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 hopefully continue in the

21. See H.R. 2454 §311 (proposed CAA §743(e)); S. 1733 div. B, §101 (proposed CAA §744(e)).

22. H.R. 2454 §311 (proposed CAA §743(e)(1)(B)); S. 1733 div. B, §101 (proposed CAA §744(e)(1)(B)).

23. H.R. 2454 §311 (proposed CAA §743(e)(4)); S. 1733 div. B, §101 (proposed CAA §744(e)(4)).

24. H.R. 2454 §311 (proposed CAA §743(e)(2)); S. 1733 div. B, §101 (proposed CAA §744(e)(2)).

25. H.R. 2454 §311 (proposed CAA §743(e)(5)); S. 1733 div. B, §101 (proposed CAA §744(e)(5)).

26. H.R. 2454 §311 (proposed CAA §743(e)(6)); S. 1733 div. B, §101 (proposed CAA §744(e)(6)).

27. 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. S. 1733 div. B, §101 (proposed CAA §744(e)(6)(D)).

28. H.R. 2454 §311 (proposed CAA §743(e)(1)(E)); S. 1733 div. B, §101 (proposed CAA §744(e)(1)(F)).

29. H.R. 2454 §311 (proposed CAA §753); S. 1733 div. A, §322 (proposed CAA §753).

Senate under the leadership of Senators Kerry, Graham, and Lieberman. Convincing the Senate to make a relatively small number of strategic changes to the existing international offset provisions could make significant progress toward meet-

ing the goal of creating a highly functional international offsets program capable of achieving its environmental and cost-containment purposes.