



Memo on EENR Center Project to Examine Barriers and Solutions to Integrating EU and US Carbon Markets, particularly issues concerning offset definition – November 2008

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Background:

It is likely that the U.S. will adopt a mandatory CO₂ (and CO₂ equivalent) control bill in either 2009 or 2010 to mitigate increasing atmospheric greenhouse gas concentration.

Though the international financial crisis may have some effect on the timing of U.S. comprehensive legislation, the election of President Obama, increasing Democratic majorities, the introduction of house draft language(Dingell-Boucher) as well as the likelihood of the EPA in an Obama administration going forward with an endangerment finding for GHGs under the CAA, all suggest that we will shortly move to debate provisions of a comprehensive bill.

There are several major bills before the U.S. Congress, with several other ideas in proposal stage, and one, the Lieberman-Warner-Boxer Bill, which has been voted out of Senate Committee, and debated in the Senate. There are several issues surrounding what should be included in such a bill, including state pre-emption, allowance of foreign offsets, involvement of developing countries, safety valves, and how the CO₂ credits will be distributed. An in-depth examination of these issues and commentary, is on the

Northwestern Law Review Colloquy at

<http://www.law.northwestern.edu/lawreview/colloquy/prior-colloquies/climate-change.html>).

With any cap and trade bill, there are important questions about how allocations will be distributed, how they will be administratively verified, whether offsets should be allowed both domestically and internationally, and who will handle the trade in the government issued permits and offsets. (Once government has created the protected property interest, i.e. a right to emit and amount certain of GHG, then these trades may be done in the private sector subject to government requirements.)

Many people in the US, the EU and developing countries interested in the benefits and advancements of worldwide trading and offsets recognize that the larger the CO₂ market that is created, the more efficient it will be.

Some have simply assumed that when the U.S. begins its own CO₂ market pursuant to federal legislation, that it will be fungible and tradable with the EU system, and that the EU and US system will continue in the current vein of using CDM offsets, but that is not necessarily true. In particular, if US offsets and trades are defined with respect to criteria in addition to tons of CO₂ and CO₂ equivalents averted, then credits not subject to this or a similar evaluation could not be freely traded in the U.S. market without some additional administrative action.

Offset Environmental Review Issues in US Legislation:

Professor Flatt, in conjunction with research advisors to the EENR Center from other academic institutions, the Nicholas Institute, the Pew Center, and Resources for the Future, has identified the issue of additional administrative scrutiny of environmental offsets in the leading US comprehensive climate change legislation (the Lieberman-Warner-Boxer Bill) as creating a distinction with the EU definition of offsets that may slow or hinder an anticipated free trading system between the US and EU's CO2 trading system. The Lieberman-Warner-Boxer Bill, in addition to requiring that all U.S. Biological offsets be analyzed for purposes of whether they are genuine and whether they will continue, also requires in both the first and second iteration (May 2008); whether system offsets will cause adverse environmental effects, or carbon "leakage" problems nearby. The Dingell-Boucher bill also seeks to "do no harm" with offset certification, and has provisions and restrictions relating to kinds of plants that can be used in biological offsets.

Importance of Offset Environmental Review Issues in US Legislation:

The existence of required administrative review on environmental and environmentally related impacts is important to the issue of whether these trades or offsets will be fully tradeable in other systems, such as the EU system. In Europe, the EU's ETS phase II also allows offsets (with certain criteria determined at the domestic level) through the CDM mechanism and the JI mechanism but these are not subject to the same kind of review

proposed in the Lieberman-Warner-Boxer Bill. Instead, these offsets are defined at the time that they are recognized as Certified Emissions Reduction (“CERs”) at the UN.¹ While EU countries could object to an introduction of a particularly grievous offset (from that country’s point of view), there is no automatic formal review beyond a list of unacceptable offsets altogether. Though we do not yet know what the EU system will look like post 2012, there has been little discussion so far of an additional environmental review provision.

It is of course possible that the ultimate U.S. climate change bill will not pass with an additional environmental review provision, but it is equally possible that such a provision will survive in this bill or be added to the bill that will eventually pass in the US.

Moreover, once such a provision is in place, it will be interpreted under normal statutory construction provisions, possibly giving it a meaning that was not directly intended. This indicates that the legislative language utilized must be carefully scrutinized if impacts on issues such as trading integration are to be understood and affected. The existence of the provision also points out the importance of additional environmental review issues in general, and if such kinds of review become more common in GHG trading systems, then

¹ Every CDM project has a cycle, starting with a project design document (PDD). This PDD contains details about the proposed CDM project, including a description of the how it will reduce GHGs, and is “additional” to reductions that would already occur in the most plausible alternative scenario. (There are different ways of measuring additionality.) It also address “leakage.” The PDD is then submitted by a project’s sponsor to an independent entity (the Designated Operation Entity, or DOE) for validation. This is then submitted to the executive board for validation. See CDM Rulebook, Baker and McKenzie, <http://cdmrulebook.org/PageID/84>. ; also Conference of the Parties Serving as a Meeting of the Parties to the Kyoto Protocol, Montreal, Nov. 28-Dec. 10, 2005, (Modalities and Procedures for CDM, p. 35) <http://cdm.unfccc.int/Reference/COPMOP/08a01.pdf>

trying to determine a way for these additional environmental reviews to be incorporated while still preserving the benefits of a larger trading system is important.

Workshops

The EENR Center, with assistance from American University, University College London, the University of North Carolina-Chapel Hill, and the Texas/UK collaborative, held two workshops composed of academics, policy makers, practitioners, and government persons to discuss this issue directly in an informal workshop setting. These workshops were able to provide a high level of analysis concerning issues of integration of a US system containing additional review provisions with the current EU system, and also explore how this kind of review might continue to play out in the creation and integration of the world's GHG trading systems.

The first of these workshops was held in London at the University College London's campus, on October 13, 2008. Confirmed and invited participants included: Professor Victor Flatt (UH EENR Center), Jill Duggan (DEFRA), Nasrine Amzour (DEFRA), Professor Michael Maslin (UCL), Marianne Knight (Deputy Director of the UCL Environment Institute), Prof. Michael Grubb, Sir David King, Lord Julian Hunt, Dr Karsten Neuhoff (Cambridge), Prof. Stephen Smith (UCL), and Dr Cameron Hepburn (Oxford). At this workshop, the participants discussed the issue and focused on whether or not the EU could be said to have an equivalent provision. There was also discussion of

the different political and legal systems in the US and the EU, and the importance of recognizing issues in US legislation before passage.

The second of these workshops was held in Washington, D.C. on Friday, November 14, 2008, at American University, Washington College of Law. Participants included: Victor Flatt (UH EENR Center, UNC-Chapel Hill), Maria-Savasta-Kennedy (UNC-Chapel Hill), Ryke Longest (Duke University), Kyle Danish (Van Ness Feldman), Praveen Kumar (UH GEMI), Tim Giuliani (Pew Center for Global Climate Change), Erica Stephan (British Embassy, Carbon Markets Team), David Hunter (American University), Bill Snape (American University), Ben Hengst (House Environment and Public Works Committee – in observation role only), and Denny Ellerman (MIT, Center for Energy and Environmental Policy Research). Unable to attend but reviewing the materials were: Marianne Knight (UCL), Mark Maslin (UCL), David Doniger (NRDC), Joseph Aldy (Resources for the Future), and Vicki Arroyo (Pew Center).

The discussion at this workshop focused on how the current “additional review” language might be interpreted, whether the policy itself is sound or necessary (i.e. whether it would already be addressed by existing environmental laws), and how probabilities for integration with the ETS could be enhanced given language such as the one in the Lieberman-Warner-Boxer or Dingell-Boucher bill.

Several points from both workshops merit attention:

The importance of having an additional environmental review provision was debated, with much discussion as to whether it is truly needed, whether environmental problems with offsets would be addressed under existing environmental laws, and whether problems that do exist should be taken care of in a different manner. In particular, many of the EU participants suggested that additional environmental review problems should be dealt with under other laws, and that a trading/offset scheme should be just that. Persons in the US who are putting together offset projects, however, seem particularly concerned that large scale land use changes may not always trigger the environmental review that is needed, and that some catch-all review might be necessary to avoid unintended consequences. The wetlands 404 permitting law was used as an example of how small land changes could have large cumulative impacts, and Washington's land conversion law was held up as an example of how land conversion can create environmental issues not covered adequately under other laws. How much NEPA would apply to offset certification was also debated, with disagreement on how widely NEPA review would actually apply. Whether the review could be limited to known concerns (such as land conversion) was debated.

In terms of possible ways to blunt impacts of trading system integration if such a policy were maintained, the proposed solutions varied from the aforementioned specification of a limited number of possible factors to review, to altering statutory language to direct the Administrator (of the EPA) to do an analysis to approve the EU system up or down for trading (while considering all informal environmental review) to directing the

administrator to create rules to implement the adverse environmental review in some numerical way that could be applied to offsets from outside the system.

Encouraging negotiations on offset verification and definition generally with the EU and internationally was also noted as a very important point.

Given the discussions at these Workshops, the EENR Center makes the following preliminary recommendations:²

- 1) The necessity of additional environmental review in comprehensive U.S. Climate Change legislation should be examined, and in particular, studies should be done on environmental impacts of various offsets that might be certified that would not be addressed by other environmental laws.
- 2) If it is determined that significant environmental harm is a problem (in that these harms would not be addressed by enforcement of other US environmental laws), the bill drafters should analyze whether these can be grouped into a few known subsets or whether there are so many areas that it would be difficult to categorize.
- 3) If the environmental harms can be grouped into a small number of subsets, proposed legislative language should be altered to require the EPA to address only these impacts in approving an offset. Moreover, language specifying exactly how these factors should count would also be desirable.

² These recommendations are from the EENR Center only, and do not necessarily reflect any official or unofficial views of any participants in the Workshops.

- 4) If the environmental harms are too numerous to be grouped in this manner, the proposed legislative language should be changed to instruct the EPA to create numerical categories to assist in evaluating environmental impacts of proposals (such as the hazard ranking system from CERCLA).
- 5) If the bill goes forward with additional environmental review provisions, the Administrator should be tasked with consulting with the EU to try to make the systems as easy to integrate as possible, given the domestic offset review provisions.