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May 2010 Update Note on The State of California Air Resources Board (ARB) Proposed Cap and Trade Regulation

The attached document provides an overview of the California Air Resources Board (ARB) conceptual design for California's proposed cap and trade program. The conceptual design is known as the "Preliminary Draft Regulation" or PDR. This document was released in November 2009, and is considered to be a first draft.

Since releasing that draft, ARB has received over 130 comments; the PDR has gone through extensive review based on stakeholder feedback. As part of this process, the GCF sponsored a technical meeting in California in February 2010 to explore the inclusion of Reducing Emissions from Deforestation and Degradation (REDD) forest carbon credits into California's system. Additional technical analysis and public input over the next few months, including input from ongoing GCF technical and partner meetings will continue to inform California's cap and trade program design.

Specific program design in the PDR will change in response to ARB staff analysis and stakeholder input. ARB will consider a cap and trade regulation for adoption in late 2010. Key details on the role of international forest carbon credits in California's cap and trade program will continue to be worked out through the remainder of 2010 and into 2011.

1

BACKGROUND AND DESCRIPTION CALIFORNIA'S CAP AND TRADE REGULATION

California's landmark Global Warming Solutions Act of 2006 (AB 32) requires the reduction of greenhouse gas emissions in California to 1990 levels by 2020. AB 32 designated the California Air Resources Board (ARB) as the regulatory authority responsible for implementing AB 32. In December 2008, ARB adopted the Climate Change Scoping Plan, as called for under AB 32, which identifies a range of direct GHG reduction measures and market mechanisms for reaching the AB 32 emissions reduction target¹. ARB has already adopted many of the measures identified in the Plan, including the country's first Low Carbon Fuel Standard and vehicle emission standards, as well as early action measures to reduce GHG emissions from the trucking industry, semiconductor industries, electrification of ships at ports, and consumer products. The Scoping Plan also identified the development of a cap-and-trade program as one of the tools that the State will use to reach its 2020 target. Preliminary draft regulatory language for the California cap-and-trade program was released in November 2009 by the ARB².

Governors' Climate and Forest Task Force

In 2008, as part of the State's leading role in developing subnational approaches to climate change, Governor Schwarzenegger signed a series of Memoranda of Understanding (MOUs) with U.S., Brazilian,

¹ <http://www.arb.ca.gov/cc/scopingplan/scopingplan.htm>

² <http://www.arb.ca.gov/cc/capandtrade/meetings/121409/pdr.pdf>

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and Indonesian states and provinces at the first Governor's Summit on Climate Change in 2008. Among other things the MOUs called for cooperation among the MOU signatories to advance efforts to include REDD and other international forest carbon activities in emerging GHG compliance systems. In order to advance these goals, the MOU states and provinces established the Governors' Climate and Forest Task Force (GCF) in 2009 with support from the Moore and Packard foundations.

The GCF has been meeting regularly since early 2009 to provide guidance to emerging carbon markets to develop high quality forest carbon credits on both the demand and supply side. To date, it analyzed existing protocols, conducted a preliminary needs assessment for REDD readiness among partner states and provinces, and is in the process of developing design recommendations for REDD provisions in emerging GHG compliance systems in the U.S. and elsewhere.

Cap-and-Trade Preliminary Draft Regulation

In November 2009, ARB released its Preliminary Draft Regulation (PDR) for a proposed Cap-and-Trade program. The PDR conveys, at a conceptual level, ideas on how to design a broad-based multi-sector cap-and-trade program, and combines preliminary regulatory language on cap-and-trade process and structure, along with narrative text that describes significant issues for which specific regulatory language has not yet been developed. In some cases, placeholders mark areas where language will be developed in the next draft. For international forest carbon, while the PDR includes a discussion of REDD, ARB has not yet determined how REDD credits could fit into the regulatory framework.

Release of the PDR was a key step in the on-going cap-and-trade rulemaking, which will include continuing public outreach and discussion with stakeholders. The second draft of the regulation is scheduled to be released in the Spring of 2010, to be followed by a public comment period. This second draft will provide a more complete look at staff's thinking on the structure and content of the cap-and-trade regulation. A final draft will be released in late summer of 2010. The Board is scheduled to consider for adoption the cap-and-trade regulation by late 2010. The regulation taken to the Board this fall will include staff recommendations for all the core regulatory provisions needed to initiate the cap-and-trade program by January 1, 2012. As ARB continues to work toward the Board's consideration of the regulation this fall, the provisions discussed below will remain subject to revision, and some portions not needed for the initial operation of the program may be deferred to later regulatory action by the Board. In addition, the Board itself may accept, reject or modify any of the provisions proposed by staff.

Overview of Preliminary Draft Regulation (PDR) for a Cap-and-Trade Program

California's cap-and-trade program would establish a cap covering about 85 percent of the State's GHG emissions and allow trading to ensure cost-effective emissions reductions. The PDR sets up the framework and requirements for participation in the cap-and-trade program and covers both stationary and mobile (i.e. transportation fuels and natural gas) sources of GHG emissions under an aggregate declining emissions cap that supports achieving the 2020 emissions target. Emissions trading and limited use of offsets will provide flexibility for covered entities to comply.

Entities that fall under the cap are identified as 'covered entities' in the PDR. The PDR creates two compliance units for covered entities to use for compliance:

1. Permits to emit are called allowances and are issued by the State. The cap is established by the number of allowances issued in a given year. As the cap declines each year, fewer allowances would be issued. Limiting the number of allowances issued in this fashion ensures emissions continue to decline.
2. Covered entities could also buy offset credits in lieu of buying allowances or reducing their emissions on-site. Offsets are tradable credits that represent GHG emissions reductions that are

made in areas or sectors not covered by the cap-and-trade program. An allowance and an offset credit are equal to one metric ton of GHG emissions.

Compliance periods for the cap-and-trade program are currently proposed to be 3 years, the first running from 2012-2014. At the end of each compliance period, a covered entity would be required to surrender allowances and offsets - equal to its total GHG emissions during that compliance period. Once the allowances and offsets are surrendered they are permanently retired by ARB. Failure by a covered entity to surrender sufficient allowances to match its emissions would result in penalties.

The program will cover about 600 of the state's largest GHG-emitting stationary sources (primarily industrial sources and electricity generators) as well as electricity imports. It will also cover emissions from transportation fuel combustion (e.g., gasoline, diesel, ethanol), and from fuel combustion at stationary sources that fall below the threshold for direct inclusion in the program (e.g. residential and commercial natural gas combustion), by covering the upstream suppliers of fuel to these sources.

In 2012, stationary sources over 25,000 MMT (industrial facilities, refineries, power plants) and imported electricity will be subject to the cap. Transportation and other fuels may be phased in during the second compliance period in 2015, or may be included at the beginning, in 2012. The regulation adopted by the Board will specify whether fuels will be in the program from the start or will be phased in starting in 2015.

Limit on the Use of Offset Credits

The Scoping Plan called for a limit on offsets that is 49 percent of the emissions reductions expected from capped sectors from 2012 to 2020. This quantitative limit helps provide balance between the need to achieve meaningful emissions reductions from capped sources with the need to provide sources within capped sectors the opportunity for low-cost reduction opportunities that offsets can provide.

Since individual facilities do not have a specific reduction goal under cap-and-trade, this limit refers to the total reductions for all sources under the cap between 2012 and 2020. In the PDR, ARB translated the aggregate quantitative limit of 49 percent of reductions into something that could be applied to each covered entity in the program. Based on our preliminary estimates, we expect that covered entities will emit a cumulative total of approximately 3,060 million metric tons (MMT) of greenhouse gases between 2012 and 2020 from all compliance instruments (offsets and allowances). During that same time period, the declining cap for covered entities will decline by about 250 MMT compared to the initial cap level. Of these emission reductions, staff is proposing to allow 49 percent of them, or **122 MMT**, to come from offsets.

ARB then calculated the portion of offsets that each covered entity would be allowed to surrender as part of its compliance obligation for each compliance period. We do that by taking the 49 percent of expected emission reductions (122 MMT) and dividing this number by the total expected emissions from covered sectors over the nine year period, 3,060 MMT of CO₂e. The result on a per entity basis is 4 percent, meaning that a covered entity could use offsets for up to 4 percent of what it surrenders at the end of a compliance period.

Available Tons from Offsets

Given the preliminary cap numbers in the PDR, up to be about 8 MMT CO₂e of offset credits could be used in each year of the first compliance period. If transportation fuels are included in the first compliance period, this would double the emissions covered by the program from the start, and about 16 MMT of offsets could be used per year.

Linkage

The Scoping Plan called for California to develop a cap-and-trade program that would link to other trading systems in the Western Climate Initiative (WCI). The PDR includes requirements for linking with other trading systems. These trading systems could be other emissions trading systems, such as the WCI, or systems that only credit offset reductions, such as the CDM. Linkage would be implemented through agreements with other systems for all details of the cap-and-trade program operations. This would include verification of emissions; certification of offsets based on approved protocols; tracking, registration and reporting systems; and related infrastructure that records and tracks emissions, allowances and offsets, along with verification of compliance in a given compliance period. The PDR also includes a placeholder that discusses what would be required to accept offset credits issued by external programs, including international offset credits or those generated through sector-based crediting.

Offset Credits

The PDR would allow limited use of high quality offsets to be used to meet compliance obligations and outlines general regulatory requirements for offsets. Multiple paths toward allowing offsets into the system are described in the PDR, and ARB is continuing to evaluate which of these should be incorporated into the final regulation. Offsets must meet rigorous criteria that demonstrate that the emissions reductions are real, permanent, verifiable, enforceable, and quantifiable. To be credited as an offset, the action or project must also be additional to what is required by law or regulation or would otherwise have occurred. The reductions must also result from a project activity that is not covered by the cap-and-trade program. The PDR describes the requirements that would need to be met for ARB to issue or approve an offset credit that could be used by a covered entity instead of turning in an allowance.

Procedures for issuing offsets by ARB and External Programs

The PDR proposes for consideration two types of offset credits: those created by ARB and those created by an external program that has been approved by the Board according to rules established in the linkage section (Sub article 12) of the regulation.

For offset credits created by ARB, ARB would be the credit issuing body. A credit issuing body reviews all project quantification and verification information to determine if a reduction, avoidance, or sequestration of GHGs has occurred. Once the credit issuing body determines that the reduction occurred, it issues an offset credit, which represents a ton of GHG reduction, by assigning a unique serial number for that specific ton. In this scenario, projects being issued offset credits by ARB must use quantification methodologies that are approved by the Board. Board-approved methodologies would consist of standardized methods for estimating project baselines and determining additionality. The PDR conceptually lays out requirements for Board-approved methodologies including: quantification, additionality, baselines, accounting for leakage and uncertainty, no net harm, permanence, crediting periods, monitoring and reporting and verification.

For offset credits issued by an external program the PDR identifies criteria and eligibility for linkage to external GHG emissions trading systems (ETS) and GHG offset crediting systems. All linkages would need to be approved by the Board. The PDR identifies mechanisms needed for enforcement purposes, such as an MOU. ARB would need to formalize enforcement agreements for all phases of cap-and-trade program operations with other jurisdictions, as well as program operation agreements with the linked program. WCI Partner jurisdictions offset credits would need to be approved through linkage provisions. These two approaches provide a starting-point for discussing offset crediting options through public outreach and stakeholder participation.

The PDR includes a lengthy narrative discussion of staff's preliminary thinking about international offset credits. This section discusses California's desire to work at the international level to reduce GHG emissions and support the adoption of low-carbon technologies and sustainable development in

developing countries. The Scoping Plan describes California's intent to move beyond international project-based crediting towards the development of international sector-based crediting mechanisms to achieve emissions reductions. The PDR acknowledges California's ongoing participation in international forest carbon activities including sub-national REDD efforts.

The PDR also provides preliminary rules and a regulatory framework for how project-based and sector-based credits could possibly be developed as part of an offsets program. It includes specific provisions for project-based offset credits issued to projects located in the U.S., Canada and developing countries, including that the project types must be approved by the Board. There are specific provisions for sector-based credits including the approval of sectors and crediting baselines. ARB is continuing to develop this regulatory framework. In doing so, staff is considering requirements to ensure a high-quality regulatory framework for including activities to reduce emissions from international forest activities.

Any and all offsets must come from sectors that are outside of capped sectors. For example, California's forest sector is not subject to the overall cap and California forest landowners are not required to hold allowances equal to their emissions. Attachments A (Linkage) and Attachment B (Offsets) provide guidance on the relevant sections in the PDR.

How Will the California Cap-and-Trade Program Work Under a Federal System?

While Federal climate change legislation is still being debated in Congress, ARB is moving forward with the development of a cap-and-trade program. Once a federal program is in place, California along with states and provinces in other regional cap-and-trade programs (e.g. WCI, the Regional Greenhouse Gas Initiative, and the Midwestern Regional Greenhouse Gas Reduction Accord) will work to link and/or transition to the national program.

California programs continue to influence federal actions on greenhouse gas emission reductions. There are many examples of how California has led the way in creating well-crafted performance standards. Last year, for example, EPA Administrator Lisa Jackson announced that the EPA will place limits on GHG emissions from vehicles nationwide and require industries to report its emissions. This started in California. Lisa Jackson acknowledged as much in her televised address when she stated “State action has been critical to getting us to the point we are today.” California created the nation’s first greenhouse gas inventory through the Climate Action Registry. It also paved the way for nationwide limits on GHG emissions from passenger vehicles seven years ago, authorizing the first auto GHG exhaust limits in the world. This past June, the EPA granted California its hard-fought waiver, allowing ARB to enforce these rules, which will limit global warming emissions from new passenger vehicles sold in California by as much as 22% in 2012 and 30% in 2016. As a result, ARB is working with federal agencies and international automakers to establish national standards as stringent as California’s for all vehicles sold in the US starting in 2012. As the cap-and-trade program continues to be refined, ARB will continue to work closely with federal representatives to help inform the federal program as it is being developed.

Attachments A and B and Tables 1 and 2 provide an outline to the preliminary draft cap-and-trade regulation (PDR) and excerpts from the PDR. The PDR is part of ARB's ongoing cap-and-trade rulemaking and is subject to continuing public discussion and stakeholder input and therefore subject to substantive change.

**ATTACHMENT A
PRELIMINARY DRAFT REGULATION OUTLINE
CALIFORNIA CAP-AND-TRADE REGULATION**

The Preliminary Draft Regulation (PDR) describes three options for ARB's role in the issuance and acceptance of offset credits. ARB is continuing to evaluate which of these options should be incorporated into the final regulation; more than one option may be included. ARB could: (1) become the sole credit issuing body; (2) it could approve offset credits issued by external programs, or (3) it could both approve credits from external programs and issue offset credits itself.

The charts below provide guidance to specific sections in the PDR that workshop participants may wish to review:

- A. Table 1 outlines subarticle 12 Linkage to External Trading which provides for requirements for offset crediting systems that links to California's program.
- B. Table 2 outlines subarticle 13, which describes the general rules for ARB to issue its own credits.
- C. Attachment B is an excerpt from the PDR that describes ARB staff's recommended approach for sectoral crediting.

For discussion purposes, initial staff thinking is that international forest carbon crediting for offsets would fall under a sectoral-crediting scheme whereby projects would nest within a sub-national program and must include a pre-determined baseline and fall below target reductions.

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Table 1
Linkage to External Trading or Offset Crediting Systems
(Subarticle 12)

<p>Section 96150 General Requirements Describes the basic criteria for approving linkage to an external greenhouse gas emission trading system (GHG ETS) or a GHG offset crediting system.</p>
<p>Section 96160 Requirements for Approval of External Greenhouse Gas Emissions Trading Systems Describes the specific criteria for approving linkage to an external GHG ETS.</p>
<p>Section 96170 Requirements for Approval of GHG Offset Crediting System Describes the specific criteria for approving linkage to a GHG offset crediting system.</p>
<p>Section 96180 Types of Linkage Describes how unilateral linkages and bilateral linkages would be established.</p>
<p>Section 96190 Agreement Describes the requirements for a Memorandum of Understanding (MOU) between California and an external GHG ETS or a GHG offset crediting system for establishing linkage.</p>
<p>Section 96200 Eligible Allowance Vintages Describes the process for approving eligible allowance vintages from a linked external GHG ETS.</p>
<p>Section 96210 Suspension of Linkage Describes that ARB could suspend a linkage to an approved external program if that program no longer meets the criteria as described.</p>

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Table 2
Offset Credits
Subarticle 13

<p>Section 96220 General Requirements for Offset Credits GHG emission reductions or avoidances, or GHG sequestration that result from an offset project must be real, additional, quantifiable, permanent, verifiable, and enforceable.</p>
<p>Section 96230 Approval of Offset Quantification Methodologies Describes offset quantification methodology requirements and approval process</p>
<p>Section 96240 Requirements for Approval of Offset Quantification Methodologies Describes the requirements and criteria that an offset quantification methodology must meet in order to be approved by the Board.</p> <p>Offset Project Types Discusses the criteria that will be considered when ARB evaluates which offset project types should result in adoption of a quantification methodology</p>
<p>Section 96250 Requirements for Offset Project Operators Describes requirements for Offset Project Owners</p>
<p>Section 96260 Registration of Offset Projects for ARB Issued Offset Credits Describes the requirements that an offset project must meet in order to be registered by ARB</p> <p>Discussion Sections: Where Should California Issue Offset Credits? Describes several options for where projects may be located for which ARB could issue offset credits, ranging from limiting projects to only those in California to no geographic limits. Possible geographic limits on projects for which ARB could issue credits would not necessarily mean limiting the geographic location of offset credits issued by an external program that ARB would approve under Sections 96180 through 96195.</p>
<p>Section 96270 Approval of a Renewed Crediting Period Describes the requirements and process for determination of whether an offset project may be approved for an additional crediting period.</p>

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Section 96280

Renewal of Registration for Renewed Crediting Period

Describes the process for registration of an offset project that has been approved for a renewed crediting period.

Section 96290

Monitoring, Reporting and Record Retention Requirements for Offset Projects

Describes general and project-type-specific requirements for the monitoring, reporting and record retention associated with offset projects.

Section 96300

Verification of GHG Reductions, Avoidances or Sequestrations from Offset Projects

Describes the verification requirements for reductions resulting from offset projects. Also describes the timing for submission of verification statements. Includes discussion on offset verification requirements.

Section 96310

Verifier and Verification Body Accreditation

Discusses accreditation for verification bodies that would verify GHG reductions from offset projects.

Section 96320

Conflict of Interest for Offset Projects

Identifies that the requirements for conflict of interest (COI) regards to offset projects would be similar to those laid out in the mandatory reporting regulation; these COI requirements may need to be amended in order to support the offsets system.

Section 96330

General Requirements for Issuance of Offset Credits by ARB

Describes the general requirements for the issuance of ARB offset credits.

Section 96340

Issuance of Offset Credits in an Initial Crediting Period

Describes the rules that apply for the annual issuance of offset credits in an offset project's initial crediting period.

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Section 96350

Issuance of Offset Credits in a Renewed Crediting Period

Describes the rules that apply for the annual issuance of offset credits in an offset project's renewed crediting period

Section 96360

Issuance of Offset Credits by ARB

Describes the process for determining how offset credits will be issued for GHG emission reductions, avoidances or sequestration resulting from a registered offset project. Also describes the process for notifying the Offset Project Owner of this determination

Section 96370

Registration of Offset Credits Issued by ARB

Describes how offset credits will be registered and made available to the Offset Project Owner

Section 96380

Ownership and Transferability of Offset Credits Issued by ARB

Describes rules and limitations for the ownership and transferability of offset credits

Section 96390

Cancellation of Offset Credits

Describes criteria for determining if an offset credit would need to be cancelled. Also describes what happens if an offset credit is determined to be void or invalid after issuance or acceptance of the offset credit by ARB.

Discussion of Concept: Reversals of Offset Credits

Discusses the enforcement and assessment of penalties that may be imposed if an offset credit is reversed or found to be invalid after issuance or acceptance by ARB.

Section 96400

Offset Credits Issued by External Programs

Discusses California's desire to work at the international level to reduce GHG emissions, covers international offset credits and sector-based crediting.

Section 96410

Requirements for Offset Credits Issued by an External Program for Projects Located in the United States or Canada

Describes requirements and limitations for approval of offset credits issued by an external program to projects located in either the U.S. or Canada. Also describes requirements MOUs

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and coordination needed for the retirement of offset credits in external systems

Section 96420

Requirements for Offset Credits Issued by an External Program for Projects Located in Developing Countries

Describes the requirements and limitations for the approval of offset credits issued by an external program to projects located in developing countries. Also describes requirements for MOUs and coordination needed for the retirement of offset credits in external systems

Section 96430

Requirements for Sector-Based Crediting

Describes requirements for MOUs & determination for approval of sectors and crediting baselines for credits issued under a sector-based crediting mechanism. This section is presented in its entirety in Table 3.

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ATTACHMENT B
PRELIMINARY DRAFT REGULATION OUTLINE
EXCERPT – PROPOSED SECTOR-BASED CREDITING (Section 96430)

(a) The approval of a sector-based credit will be determined by the EO based on the evaluation of the criteria consistent with those in this section.

(b) *General Requirements.* The EO may approve a sector-based credit if:

- (1) the credit is generated in a developing country;
- (2) the country, state, province or program issuing the sector-based credit is approved by the Board pursuant to Subarticle 12; and
- (3) the country, state, province or program issuing the sector-based credit has implemented substantive and procedural requirements for the relevant sector that provide equal or greater assurance of the integrity of such sector-wide GHG reductions or avoidances, or GHG sequestration as is provided by the requirements for other offset credits approved under this article.

(c) *Determination for Approval of Sectors.* The Board may approve a sector of a specific developing country, or state or province in such country, after public notice, opportunity for public comment and evaluation based on the following criteria:

- (1) the homogeneity of sources within the relevant sector;
- (2) the ability to establish a credible projection of business-as-usual GHG emissions and associated baseline for sector-based crediting of the relevant sector;
- (3) the capability of accurately measuring, monitoring, reporting, and verifying the performance of sources across the relevant sector;
- (4) the degree to which the relevant sector provides products or services that are sold in an international market and/or contributes GHGs to the atmosphere; and
- (5) the risk of emissions leakage in the relevant sector is greater if an international offset credit is issued on an individual project basis.

(d) *Crediting Baseline for Sector-Based Crediting.* A quantitative crediting baseline must be established for a sector approved by the Board, using the following criteria:

- (1) the crediting baseline must either be an absolute GHG emissions level, a GHG emissions intensity level calculated as GHG emissions per unit of production, or a technology standard;
- (2) in the case of an absolute GHG emissions level, the crediting baseline for the relevant sector must be established at a lower level of GHG emissions than would occur under a business-as-usual scenario;

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- (3) in the case of a GHG emissions intensity level, the crediting baseline for the relevant sector must be established at a lower level of GHG emissions per unit of production than would occur under a business-as-usual scenario, and it must be possible to calculate specific quantities of GHG emissions abated as a result of reduced GHG emissions intensity below this crediting baseline;
- (4) in the case of a technology standard, the crediting baseline must be established at a higher technology standard or higher percentage of adoption of a particular technology in the sector than would occur under a business-as-usual scenario, and it must be possible to calculate specific quantities of GHG emissions abated as a result of adoption of technology above this crediting baseline;
- (5) to set the crediting baseline, the country, state, province or international program issuing the sector-based credit must take into account the relevant current and historical trends in the sector as well as domestic and international policies or incentives to reduce GHG emissions, sequester GHG, or improve technology adoption; and
- (6) the additionality and the performance of the sector will be based on the crediting baseline established under this subsection.
- (7) [Placeholder]: Provisions to be developed.

(e) *Agreements for Sector-Based Crediting.* ARB must establish a MOU with the jurisdiction in which the GHG reduction activities occur, which will specify the quantification and issuance of sector-based credits. ARB will work through an agreement, arrangement or technical cooperation with an approved developing country or state or province in such country to ensure that such program:

- (1) is notified of ARB's approval of its crediting program;
- (2) provides appropriate enforcement provisions including verification of GHG emissions and GHG emission reductions, sufficient tracking and registration systems and related infrastructure that will record and track GHG emissions and GHG emissions reductions; and
- (3) provides for the disqualification of credits issued by that system for subsequent use under any system whether such use is a sale, exchange, or submission to meet a surrender obligation in any GHG.