

Another look at additionality

Eron Bloomgarden and **Mark Trexler** argue for a top-down approach to assessing carbon offset project additionality

In March's *Environmental Finance*, Bill Reynolds argues that financial additionality testing for greenhouse gas (GHG) offset projects should not be altogether eschewed, despite its flaws (see page 36). While we would not argue with this, we would stress the importance of applying a benchmark approach to the issue, as the US develops a federal GHG policy.

As a refresher, financial additionality involves evaluating whether a project would have been economically feasible in the absence of carbon finance; if so, then it fails the financial additionality test. Financial additionality is one of several potential ways to test for project additionality, which in turn is key to establishing the environmental credibility of offsets-based emissions trading.

Additionality testing is often divided into two broad categories: project-by-project approaches (bottom-up), and standardised or benchmarked approaches (top-down). The bottom-up approach, widely employed in voluntary and mandatory offset programmes, including the Clean Development Mechanism (CDM), requires each project to demonstrate that it is in fact additional when compared to a business-as-usual baseline. The top-down approach, increasingly advocated as an alternative, generally establishes an emissions performance benchmark across a sector or emissions reducing activity. Any project outperforming that benchmark would be considered additional, at least for the fraction of reductions exceeding the benchmark.

A benchmark-based determination is becoming increasingly popular because it often makes the additionality determination more objective and policy based. Indeed, the emerging consensus in the US seems to reflect a shift away from 'project-by-project' additionality determinations towards benchmarking.

Financial additionality testing is one approach to bottom-up additionality testing. In the abstract, financial additionality testing seems straightforward. In reality, however, it's much trickier. One company's business-as-usual investment may well be another's high-risk investment. And how additional is additional enough? A 1% impact on the project's internal rate of return? A 10% impact? What if financial additionality testing becomes a full employment act for accountants to demonstrate that projects fall just short of whatever financial return is considered to make a project business-as-usual? And what about projects that face very real barriers that happen not to be financial?

Because of the counter-factual nature of financial additionality determinations, the only way to truly prove that a project is additional is to deny it the ability to generate credits, and

then witness that the project didn't get built. Any financial additionality testing short of such a draconian approach is inevitably based on a subjective determination. The bottom line is that financial additionality testing will allow some fraction of non-additional reductions to qualify as offsets, while excluding from the pool some fraction of truly additional reductions.

The problems faced by financial additionality testing are not isolated. No additionality test can ever be perfect. There will always be some fraction of non-additional reductions that slip through any testing process into the credited offset pool, and some fraction of truly additional reductions that are denied crediting. The real challenge facing additionality policy is how to ensure that these two outcomes are balanced in a way that is acceptable to policy-makers, and that delivers a politically viable price for offsets.

The fact that additionality testing is difficult doesn't mean we can simply ignore it. In a compliance system, each ton of credited offset allows a ton to be emitted elsewhere within the cap. The magnitude of potentially available non-additional reductions, which includes segments of business-as-usual reductions within energy efficiency, renewable energy, tree-planting and even nuclear energy, is enormous. Crediting even a fraction of these billions of tons of non-additional reductions would undercut the environmental integrity of almost any emissions trading system.

Acknowledging the critical importance of maintaining the environmental credibility of offset programmes, while recognising the challenges that have faced project-by-project additionality testing, has led more and more observers to suggest adoption of a benchmarking-based alternative for determining additionality. A significant advantage of benchmarking is that it lowers project-specific transaction costs. Moreover, counter-factual baselines don't need to be produced for each individual project, nor do they have to be negotiated and verified on a case-by-case basis. At the same time, much more up-front work is required to determine the benchmarks in the first place, which is a key reason project-by-project additionality testing has been so prevalent to date.

The challenge faced by a benchmarking approach is the same one faced by any additionality testing; namely to manage the number of non-additional reductions being accidentally credited, while trying to minimise the number of truly additional reductions that are denied

crediting. There are always some business-as-usual projects that go well beyond standard practice, and would be credited under a benchmarking system. There are also very real reduction opportunities that don't make it to the level of the benchmark, and that are inappropriately denied crediting.

As already noted, no additionality testing system can be perfect. However, a benchmarking approach may well prove to be much simpler for carbon markets to adapt to, significantly reduce transaction costs, and be at least as good as financial additionality testing from the standpoint of environmental integrity. A number of entities are already working on the design of benchmarking systems that advance these objectives. In the US, the Regional Greenhouse Gas Initiative (RGGI) uses a benchmarking-based approach, while the California Climate Action Registry (CCAR) is also developing "standardised GHG reduction project protocols for specific industry sectors that are based on internationally recognised best practices". So far, the registry has created a set of forestry protocols, as well as a protocol for manure management and one for landfill gas capture. The Voluntary Carbon Standard also provides an option to use a performance standard approach to additionality.

After nearly two decades of debate and discussion, there is renewed urgency to agree on what we mean by 'additionality', and on the preferred means to test for it in the US market. The emerging carbon market in the US has the potential to unlock a tremendous amount of investment capital, and stimulate the development of large numbers of emission reduction projects. First, however, we need to convince policy-makers that we can learn from our experience with offsets, and that benchmarking-based additionality testing should have an important role to play.

Eron Bloomgarden is country director for the US and Mark Trexler is managing director, global climate services, at project developer EcoSecurities. E-mails: eron@ecosecurities.com, mark.trexler@ecosecurities.com

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