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July 28, 2008

Midwestern Greenhouse Gas Reduction Accord Advisory Group
c/o Mr. Jesse Heier
Washington Director
Midwestern Governors Conference
Council of State Governments
444 North Capitol Street, NW
Suite 401
Washington, D.C. 20001

Dear Advisory Group Members:

The American Forest & Paper Association (AF&PA) appreciates the opportunity to share our perspective on the Midwestern Greenhouse Gas (GHG) Reduction Accord.

AF&PA is the national trade association of the forest products industry, representing forest landowners and pulp, paper, paperboard and wood products manufacturers. Our companies are in the business of producing products essential for everyday life from renewable and recyclable resources that sustain the environment. The forest products industry accounts for approximately 6 percent of the total U.S. manufacturing output and employs more than a million people with an estimated annual payroll exceeding $50 billion. In the states participating in the Midwestern GHG Reduction Accord, the forest products industry employs approximately 190,000 people with an estimated annual payroll exceeding $10 billion.

Since the forest products industry is comprised of those who plant and grow trees, and those who use timber and recovered paper as raw material to manufacture the forest products that are part of our everyday lives, we are uniquely affected by climate change policy. Below is a summary of the key points contained within our more detailed comments (attached) on the Accord and its development. These comments focus on the cap and trade approach being pursued under the Accord. However, there are other policy options available which may be better suited to a regional approach. Whichever policy approach is ultimately taken, manufacturers should be dealt with in a way minimizes costs and increases global competitiveness.

Competitiveness Concerns

- The forest products industry faces increasing domestic and international challenges -- increasing energy costs and global competition. U.S. imports of forest products have grown consistently at a faster rate than American exports, resulting in an ever-widening trade deficit in the sector. Imposing climate change regulation on U.S. manufacturing without requiring equal actions from other high-emitting countries will weaken U.S. manufacturing competitiveness. Similarly, imposing regional climate change regulation in the absence of a global program will weaken the competitiveness of manufacturing in the Midwestern region.

- AF&PA believes the best U.S. climate change policy option for addressing competitiveness concerns is to make the program costs as low as possible for U.S. industry. This means designing multi-sector programs, allocating (versus auctioning) allowances to the manufacturing sector, instituting flexible offsets, and timing emissions cap reductions with the availability of new energy efficient technology.

Allowances

- Allocating allowances proportional to historical emissions is essential for maintaining a viable forest products industry in the United States. The forest products industry has limited ability to pass along increased costs to its customers due to increasing foreign competition. Therefore, the industry will have to absorb the cost of reductions, as well as those of the electric power and petroleum distribution sectors that are passed on in the form of increased electricity and fuel prices. Without an adequate allocation of long-term allowances, the U.S. forest products industry would see its slim profit margins significantly reduced or eliminated. It is likely that many facilities would shut down, and production (and jobs) would shift to other (unregulated) regions of the United States or foreign countries.

Offsets

- Allowing use of offsets to mitigate emissions regulated by a cap and trade program is an important component for limiting costs of the program. There should be broad flexibility in allowing real, verifiable offset credits that a company can generate or purchase to mitigate its GHG emissions. There should be minimal or no limits on the number of offsets allowed by the policy.

- Managed forests and forest products should be eligible for offset credits because of their unique ability to sequester and store carbon. Recycling activities should also be eligible for offset credits since they reduce methane emissions by keeping paper out of landfills and reduce energy required for a number of paper products. Recovering paper also extends the fiber supply and contributes to carbon sequestration.

Timing of Reductions with Availability of Technology

- Timing emissions cap reductions with the availability of new energy efficient technologies is critical. The development and implementation of new technology is essential to achieving the ambitious goals outlined in current legislative proposals. The timing of the decline in caps should take this into account to avoid unnecessary short-term escalations in energy costs that could force companies out of business before new technology can come online.

Again, we appreciate the opportunity to comment on the design of the Midwestern Greenhouse Gas Reduction Accord. Its design is not only important to our members operating in the Midwest region, but to all of our members, as the Accord will likely play an important role in shaping a national program.

Please do not hesitate to contact me if you have any questions regarding our comments.

Sincerely,

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American Forest & Paper Association

Comments on Midwestern Greenhouse Gas Reduction Accord

July 28, 2008

The American Forest & Paper Association (AF&PA) appreciates the opportunity to comment on the Midwestern Greenhouse Gas Reduction Accord (MGA) related to the design of a cap and trade-based approach for reducing greenhouse gas (GHG) emissions.

The American Forest & Paper Association is the national trade association of the forest products industry, representing forest landowners and pulp, paper, paperboard and wood products manufacturers. Our companies are in the business of producing products essential for everyday life from renewable and recyclable resources that sustain the environment. The forest products industry accounts for approximately 6 percent of the total U.S. manufacturing output and employs more than a million people with an estimated annual payroll exceeding $50 billion. In the states participating in the Midwestern GHG Reduction Accord, the forest products industry employs approximately 190,000 people with an estimated annual payroll exceeding $10 billion[1].

The forest products industry's carbon footprint is unique. A significant portion of our energy needs are met through the use of carbon neutral biomass, with the remainder largely from fossil fuel. We also sequester carbon in our forests and the many products we produce. Consequently, the industry will be affected by the myriad of policies being designed to decrease carbon dioxide ($CO_{2)}$ levels in the atmosphere. Of particular importance to the forest products industry is the increase in energy costs that will result from a cap and trade program.

Because we operate in very competitive global markets, this industry has to continually look for ways to reduce costs. Since 1972, AF&PA member pulp and paper mills have decreased the use of fossil fuels and purchased energy per ton of product by 56%. More recently, from 2004 to 2006 alone, we reduced the use of fossil fuels and purchased energy per ton of production by 9%. Since the early 1970s, the industry has intensified the use of wood residuals (biomass) for most of our heat and power needs. In 2006, AF&PA member pulp and paper mills generated 64% of the energy they used from biomass; members' wood products facilities generated 74% of their energy from biomass. Currently, our industry is a leader in the use of energy efficient combined heat and power (CHP) systems (29 percent of all U.S. co-generated electricity is produced by pulp and paper mills). Between 2000 and 2006, AF&PA members reduced their GHG emissions intensity by 14 percent. If direct and indirect emissions are totaled there has been a decrease of 24.6 percent, falling from 88.0 million metric tons of CO_2 equivalents to 66.3 million metric tons. Approximately half of this reduction can be attributed to improvements in

[1] Does not include Manitoba or observers

GHG emissions reductions, such as efficiency improvements or reduced fossil fuel use, and half can be attributed to decreases in production and changes in baseline from the year 2000.[2]

We have also increased our use of recycled fiber, which extends the fiber supply, contributes to carbon sequestration, and reduces the energy required to manufacture a number of paper products. It also helps reduce the amount of discarded paper going to landfills, thus avoiding methane emissions.

The forest products industry faces increasing domestic and international challenges -- increasing energy costs and global competition. U.S. imports of forest products have grown consistently at a faster rate than American exports, resulting in an ever-widening trade deficit in the sector. Imposing climate change regulation on U.S. manufacturing without requiring equal actions from other high-emitting countries will weaken U.S. manufacturing competitiveness. Similarly, imposing regional climate change regulation in the absence of a global program will weaken the competitiveness of manufacturing in the Midwestern region.

Structure of a Cap and Trade Program

Three key components of a cap and trade program that will be essential for mitigating costs of compliance, as well as increased energy costs, are policies related to allowance allocation, allowing the use of offset credits and the timing of required reductions.

Providing an adequate level of allowances proportional to historical emissions is essential for maintaining a viable forest products industry in the United States. With little ability to pass on costs in a competitive world economy, the U.S. forest products industry would see its slim profit margins significantly reduced (or eliminated) if large sums of money were required to purchase emission allowances. For example, in the pulp and paper portion of our business (the portion of the industry with the majority of emissions), our members' annual profits averaged about $4.3 billion per year from 2000-2007. Meanwhile, in 2006, members' pulp and paper facilities emissions were 66.3 million metric tons carbon dioxide equivalents. At an allowance price of $30, purchasing allowances at auction would cost pulp and paper manufacturers $2.0 billion dollars or almost half of their profits. At $50 per ton, three-fourths of the pulp and paper sectors' profits would be eliminated. It is likely that many facilities would shut down, and production (and jobs) would shift to other (unregulated) regions of the United States or foreign countries.

A robust and flexible offset use policy can also serve to mitigate the costs of the program by moderating the price of allowances in the market. The inclusion of lower cost reductions from sinks and emission reduction projects from outside the regulated sectors is fundamental to the goal of achieving lowest cost reductions of greenhouse gases in the atmosphere.

Timing emissions cap reductions with the availability of new energy efficient technologies also is critical. The development and implementation of new technology is essential to achieving the ambitious goals outlined in current legislative proposals. For example, most experts agree that many significant issues need to be resolved before carbon capture and storage can be widely implemented. The timing of the decline in caps should take this into account to avoid unnecessary short-term escalations in energy costs that could force companies out of business before new technology can come online.

Allowances

[2] http://www.afandpa.org/Content/NavigationMenu/Environment_and_Recycling/Environment,_Health_and_Safety/Reports/AF&PA_EHSReport08_final5web.pdf

Allowances should be granted to the manufacturing sector--especially those segments with limited ability to pass increased costs through to their customers--versus having to purchase them at auction**.** Allowances should be distributed based in proportion to historical emissions. Basing allocations in proportion to historical emissions should also allow for an equitable straightforward integration into a future national program. In addition to historical emissions, indirect costs imposed on industry sectors should be taken into account when determining the apportionment of allocations. Any charge for carbon emissions will foster responses beyond just the emitting entities paying more for those emissions. For example, a price on carbon will increase the demand (and price) for natural gas, particularly by the power generation sector. This development would increase the cost structure in our industry and put us at an even greater competitive disadvantage. Unlike the regulated electric power generation and petroleum sectors, the manufacturing sector–in particular the forest products industry–has limited ability to pass along increased costs to its customers. Therefore, the industry will have to absorb the cost of reductions, as well as those of the electric power and petroleum distribution sectors that are passed on in the form of increased electricity and fuel prices. Specifically, the forest products industry will have to pay for its emission reductions or allowances to cover its direct emissions, the cost of allowances purchased by the utilities as well as the opportunity costs of the allowances the utilities are granted passed through in higher electricity costs, increased natural gas prices, increased electricity prices due to higher fuel costs of the utilities, and higher raw material costs for biomass due to higher demand for biomass as a carbon neutral fuel. Allowances should be allocated to cover these costs until new technologies are available and competitiveness and leakage concerns are mitigated.

To prevent inequities experienced under the EU Emissions Trading Scheme (often referred to as “windfall profits”), the program should not over-allocate allowances nor allow regulated entities to pass on to customers the “costs” of allowances that were granted and awarded without costs (i.e., recipients of allowances should be obligated to record their cost as zero--$0.00). In this way, recipients would only be able to sell those allowances not needed as a result of their reducing their emissions below their “cap.” Further, one hundred percent of any revenue from that sale--other than transaction costs--would be recorded as income and subject to applicable taxes. This outcome would be consistent with a market-based approach and generally accepted (financial) accounting principles used in the U.S. and would preclude any recipient of awarded allowances from artificially realizing a financial gain. Allocations to the manufacturing sector should only decline when international competitiveness concerns have been addressed.

The rate of reduction of the cap should be timed to reasonably reflect expected gains in energy efficiency and the introduction of new technologies. Allocation should not be used to transfer wealth from the regulated community to the non-regulated community where the prospect of reducing emissions is uncertain. Regulated entities need these funds to invest in the new capital equipment and technology needed to make the required reductions. Entities that make reductions below their allocation will pay federal and state taxes on the revenues generated from the sale of excess emission allowances realized from emissions reduction investments. The latter, as noted above, creates a viable income tax base and tax revenue stream from which government programs can be funded, while optimizing the cost-effectiveness intended by adopting a market-based, cap and trade framework.

The program should also provide credit for early, verifiable reductions, including reductions made under voluntary programs such as the Climate Vision Program, Climate Leaders, Chicago Climate Exchange or via individual company commitments. Credit for early action should come from an allocation outside the cap and be limited to a ten year look back period from the start date of the program. We recommend that MGA propose some criteria that could be used to

determine a maximum "early action" look back baseline, the adoption of which would ensure some degree of consistency and integrity to the process.

Offsets

The eligibility to use project-based offsets in a cap and trade program is an important component for limiting costs of the program. Offsets also serve as a tool to promote reductions from unregulated sources. Through its unique ability to sequester carbon in forests and store it in long-lived products, the forest products industry has the capability of providing offset credits to complement a cap and trade program. Offsets can also be generated from our industry's recycling activities. In 2006, AF&PA member companies' use of recycled paper to make new paper products resulted in avoided landfill methane emissions totaling some 21.1 million metric tons of CO_2 equivalents.

There should be broad flexibility in allowing real, verifiable offset credits that a company can generate or purchase to mitigate its GHG emissions. There should be minimal or no limits on the number of offsets allowed by the policy. The availability of offset credits will help moderate allowance prices, which is particularly important prior to the deployment of breakthrough technologies needed to reduce emissions and sequester CO_2.

There should not be restrictions on the types of projects eligible for offset credits. Any project that generates real, verifiable reductions in atmospheric carbon should be considered on its own merits. Restricting offset projects by specifying allowable types will unnecessarily stifle innovation. Smaller facilities that are under established thresholds for regulation should be allowed to generate offsets.

Regulated entities should also be able to generate offset credits and incorporate them into their entity-wide inventory. Such inventories would reflect the net of emissions, emissions reductions, and sequestration. Credit for reduced indirect emissions and avoided emissions should be granted to the entity responsible for the reduction. For example, a facility that invests in cogeneration which results in a decrease in purchased power should receive credit for that reduction (rather than the electric generator getting the credit). Department of Energy (DOE) Section 1605b guidelines outline acceptable accounting protocols for indirect and avoided emissions.

This same principle underlies our opposition to energy rates based on "revenue decoupling," Under decoupling, utilities are often simply compensated for lost revenue generally, and industrial consumers therefore often lose the financial reward and a primary motivator of efficiency projects—reduced energy bills. For example, if a paper mill purchases less electricity as a result of an energy efficiency project, it should see lower bills. However, because the utility is to be compensated for the lost revenue, that same mill would end up paying a higher rate on a lesser level of purchases under decoupling, thereby not getting the "credit" for the investment in the energy efficiency project.

Offsets from Managed Forests and Forest Products

It is imperative that carbon sequestration in managed forests and forest products be eligible as voluntary offsets. Over time, sustainable forests resources store additional carbon. Much of this sequestered atmospheric carbon is transferred into long-lived forest products. The climate benefits of this process are significant. In the U.S., carbon sequestered by forests and products

each year is enough to offset approximately 10 percent of U.S. carbon dioxide emissions.[3] Forests and forest products also help offset fossil fuel emissions through the use of biomass energy and the low manufacturing energy requirements of wood products.[4] More than half the forestland in the United States is privately owned–roughly 424 million acres. Of that, 354 million acres are actively managed for timber. Private landowners in the U.S. plant about 4 million trees each day.[5] In the states participating in MGA, there are over 60 million acres of forestland, of which 37 million acres are privately owned.[6]

As stated in the Intergovernmental Panel on Climate Change Fourth Assessment (IPCC) Report, *Mitigation:*

> "In the long term, a sustainable forest management strategy aimed at maintaining or increasing forest carbon stocks, while producing an annual sustained yield of timber, fiber or energy from the forest, will generate the largest sustained mitigation benefit."[7]

For these reasons, it is essential to ensure that emerging climate change policy and programs to reduce GHGs recognize and value the carbon sink benefit of forests and forest products. Doing so will help the realization of climate change program objectives, help address costs concerns of such programs, and create economic incentives to forest land owners to maintain their property as sustainable forested land. Much of the technical and analytical methodology to support this approach has been developed over the past several years.

EPA reports carbon stored in managed forests and products in its *Inventory of U.S. GHG Emissions and Sinks* reported annually to the United Nations Framework Convention on Climate Change. AF&PA specifically supports the use of the 100 year method[8] as a means for calculating carbon stored in forest products.

AF&PA believes the quantification of additional forest and forest product sequestered carbon stocks for offsets should be carried out on a stock change basis, instead of using the often-proposed beyond "business as usual" additionality approach to demonstrate change beyond a baseline. Sustainably managed lands, by definition, may not have a significant increase in carbon over time because the additional increments of annual carbon storage are found in the forest product stream that leaves the forest. The non-harvested portions of managed forests and non-managed forests that have stock increases can be included in a voluntary offset program where they can be quantified as real, verifiable and transparent inventory changes. This approach avoids the problems associated with attempting to define the rather ambiguous term "business as usual" (BAU). The use of BAU as a bright-line for defining carbon storage beyond a baseline has been, and would continue to be subject to gaming and manipulation. It is simply too subjective – i.e., it is not a constant that would be real, verifiable, and transparent.

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[3] The State of America's Forests SAF 2007 (http://www.safnet.org/aboutforestry/StateOfAmericasForests.pdf)

[4] Framing a home with wood instead of steel or concrete can save 26% to 31% greenhouse gas emissions over the life of the home (www.corrim.org)

[5] [1] Forest Resources of the United States, 2007; Draft RPA Review Tables: U.S. Dept. of Agriculture, http://www.fia.fs.fed.us/documents/pdfs/2007_RPA_REVIEW_TABLESv2c.pdf;
Tree planting in the United States - 1999; U.S. Dept. of Agriculture.

[6] Does not include Manitoba or observers

[7] (Source: IPCC. 2007. *Mitigation, Fourth Assessment Report*)

[8] Miner (2005), "The 100-Year Method for Forecasting Carbon Sequestration in Products in Use", in Mitigation and Adaptation Strategies for Global Change, published on-line May 22, 2006.

AF&PA is currently participating in a broad stakeholder effort with U.S. and Canadian forestry and environmental groups to develop North American consensus forest carbon measurement standards. The goal of these new consensus standards, developed under a process accredited by the American National Standards Institute (ANSI), is to bring together existing and emerging forest carbon measurement protocols from state, provincial, regional, and national climate policies and programs. The resulting bi-national consensus standards will establish uniform policies across North America to provide a broadly-supported basis for forest carbon protocols in both countries.

AF&PA looks forward to working with the MGA in the future on developing appropriate forestry protocols that include carbon stored in managed forests and products.

Reporting

AF&PA is in favor of one national reporting system. The MGA should use the forthcoming EPA mandatory reporting protocol (proposal due out September 2008) in order to avoid multiple reporting requirements for covered entities. In addition, special care should be given to maintaining confidentiality of certain reported data and keeping the administrative costs of reporting low.

At no time should facility level reporting of confidential business information be required or made available to the public. Most GHG data are a direct derivative of a manufacturing facility's energy use, and such information is frequently and historically deemed business confidential, especially in energy intensive industries such as the forest products industry. Facility level reports (compiled to determine an entity-wide summary) should remain private, consistent both with existing state and federal laws that provide for the protection of confidential business information and with the obligations reporting entities must conform to under U.S. federal antitrust rules. MGA–and its member states–should only engage a reporting and registry framework that, to the extent it requires facility level data, restricts the right to review and audit that data to authorized government agencies bound by state and federal rules for the protection of confidential business information.

Only regulated entities should be required to report under the MGA. Non-regulated entities wishing to report may report emissions under a voluntary program such as The Climate Registry (TCR), the Department of Energy's 1605b Program, or EPA Climate Leaders. Those providing voluntary offset projects (from outside the cap) should also have reporting requirements related to verifying the offset.

Mandatory reporting should begin before the cap commences. This will help ensure that the cap is set appropriately and baseline emissions for the allocation of allowances are calculated correctly. The level of precision for reporting GHG emissions should be in 100 or 1000 tons increments.

Third party verification should not be required under the MGA. Reporting under mandatory programs, like that practiced under traditional environmental regulations, is subject to government review and enforcement and does not require (expensive) third party audits. Companies should be allowed to attest to the veracity of their data as they do in other state and federal environmental programs and be subject to state authorized audits of such information. U.S. manufacturers have a long history of providing truthful emissions and other environmental

data to regulatory authorities under penalty of law. This approach is effective, has a proven record, and should be applied to this situation as well. The need for third party verification should be market-driven, not mandated by government.

Carbon neutral biomass

AF&PA would like the MGA to affirm that CO_2 emissions from the combustion of biomass are considered carbon neutral and are not regulated by the MGA program.

Nationwide, biomass comprises approximately 64% of the fuel used by AF&PA members' pulp and paper mills and 74% of the fuel used by wood products mills. The Intergovernmental Panel on Climate Change, the United States Environmental Protection Agency, the European Commission, and other internationally recognized climate policy groups have concluded that the combustion of biomass causes no net addition of CO_2 to the atmosphere. As a result, the emissions of CO_2 associated with the combustion of biomass are not included in greenhouse gas emissions totals. Reliance on biomass-based fuels is a key component of U.S. national strategy to combat climate change.

In Closing

Thank you again for the opportunity to comment on the design of the Midwestern Greenhouse Gas Reduction Accord. Its design is not only important to our members operating in the MGA region but all of our members, as the MGA will play an important role in shaping a national program.

For more information, please contact:

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