US Greenhouse Gas Mitigation Solutions: GEMCo
Comments on the “Brownback” and “Harkin” Farm Bills
Overview

Bill S932, S765 and S769 are an interesting collection of bills. They potentially combine to lay a foundation for valuing the environmental benefits of agricultural Best Management Practices, a direction the members of GEMCo strongly support.

From our perspective, the devil will be in the implementation details of these bills. The question we have is: in detailed implementation, will the bills spawn accelerated private sector demand/financing for agriculture-based carbon credits and agriculture sector-generated green tags or will they wipe out the emerging private market? They could do either.

All of the recommendations outlined in this memo are facilitated by the creation of a fungible certificate called an Agriculture Carbon Emission Reduction Credit (AG-CERC). The AG-CERC should be denominated in carbon dioxide-equivalent ton-years and should be issued by the US Department of Agriculture (DoA) in consultation with the US EPA.

Starting with Bill S932

In the context of Bill S932, the “Farm Bill”, the answer to the above question will depend entirely on the detailed determination of the Criteria for Payment and the impact of the bill on title to Carbon Emission Reduction Credits (AG-CERCs) that may be developed by the Secretary under the authority outlined in section (h) of the bill.

Recommendations #1 through #4

We recommend, in the development of the Conservation Security Act program details, serious consideration of the following strategy:

- Participating farmers should be encouraged, but not obliged, to estimate soil carbon fluxes associated with the implementation of conservation practices. The DoA could assist by producing carbon flux estimation/measurement and reporting guidelines and/or by subscribing a selection of participating fields to establish a soil carbon flux benchmarking system.

- The Secretary should establish a standard Conservation Security contract payment schedule that segregates carbon sequestration from other environmental benefits. The payment schedule should set a market price for title to AG-CERCs that may be adjusted annually. For purposes of this outline, let's set the starting market price at $2.50/ton (CO2 equivalent).

- Over the term of the contract, participating farmers should enjoy the annual option of electing either to: retain title to the past year's vintage AG-CERCs or to transfer title to the AG-CERCs to the DoA. In other words, the participating farmers do not sign over title to AG-CERCs to DoA by virtue of signing a Conservation Security Contract. But the Contract establishes the DoA as a firm purchaser of AG-CERCs if the farmer wishes to transfer title.
DoA should be obliged to publish an AG-CERC price annually, in advance.

**How It Would Work**

The bill stipulates that the maximum annual payment that could be made to a farmer that has contracted to maintain Tier 1 practices is $25,000. Let's say that it is estimated that the maintenance of a particular set of Tier 1 practices should lead to the average annual sequestration of, say, 1 tCO2e (.27 tons, carbon equivalent) per acre per year, according to the DoA estimation guidelines, over the term of the contract. Let’s say that under the Conservation Security Contract the DoA places a value on AG-CERCs equal to the investment tax credit outlined in S765, which is $2.50 per ton of carbon sequestered at this time. A particular farmer contracts to maintain Tier I practices on 3,000 acres. Each year of the contract term, the farmer can choose to: (1) accept the maximum annual payment of $25,000 and transfer title to AG-CERCs to DoA, or (2) accept an annual payment of $22,975 ($25,000 - ($2.50 * 3000 acres * .27 tons of carbon per acre)) and retain all marketable title to AG-CERCs.

**Recommendation #5**

- It should be made clear that the DoA will have the unfettered right to use, retire, auction or otherwise dispose of any AG-CERCs title to which are transferred to the DoA through the CRP/Conservation Security Program.

The intent here is not to expand the cost of the Conservation Security program in any way. Nor is it to limit a farmer’s payment potential. The recommendations are meant to ensure that the farmer retains the option of selling AG-CERC title to buyers other than the DoA. They are also meant to ensure that the Act is a compliment to and does not, quite inadvertently, kill private sector demand for agriculture sector-generated AG-CERCs or agriculture sector-generated green tags.

Obviously, as long as the DoA is offering more for a AG-CERC than the private sector, Conservation Reserve Program participating farmers will typically choose to transfer AG-CERC title to DoA. At this moment, the speculators in the nascent AG-CERC market actually typically offer somewhat more than the $2.50 per ton of carbon sequestered outlined in Bill S765 and above. But the cost of aggregating AG-CERCs to get them to buyers might still result in participants choosing to take full payment from DoA for some time.

Low private sector demand and offering prices for agriculture-sector generated AG-CERCs is due to remaining uncertainty about the potential future applicability of agriculture sector-generated AG-CERCs in the context of possible (but not certain) future energy company GHG emission caps. But once US federal law establishes the agriculture AG-CERC, private sector demand for AG-CERCs could grow a number of ways.

**Recommendation #6**

- If the current administration wishes to be more proactive (a position we would endorse), amendments to S932 could be included to provide assurance that “in the event that GHG emission caps are introduced in future federal legislation, AG-CERCs certified through the
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CRP/Conservation Security contracting process can be used as credits against those future compliance obligations, subject to possible restrictions on the banking and use of early AG-CERC vintages in later compliance years. AG-CERCs are freely transferable”.

Such language provides a general assurance of the usefulness of AG-CERCs in the event of the future introduction of domestic GHG caps. But it does not bind the administration to the introduction of domestic GHG caps nor does it bind the administration to credit early agriculture sector investments in the context of those possible caps.

Alternate Scenario
If the current administration is not yet prepared to be this proactive, it is still likely that the establishment of a transferable AG-CERC in the “Farm Bill” will spawn state actions that result in improved demand for US agriculture sector AG-CERCs. States that have or plan to introduce Renewable Portfolio Standards /Mandates will consider modifying those mandates to recognize agriculture sector-generated AG-CERCs as fungible with Renewable Energy Credits. To establish their credentials, utilities may choose to accumulate AG-CERCs and offer them to major green energy customers, or integrate them in their “green tag” programs. States that already have or plan to introduce statewide GHG emission limits or offsetting requirements could integrate recognition of AG-CERCs in their compliance regimes. All of these likely adaptive responses should result in higher demand for agriculture sector-generated AG-CERCs and could result in much more substantial payments to farmers than could be contemplated by the DoA in the Farm Bill.

Of course, this is an ideal outcome, because once such a market mechanism is in place, rural electricity supply strategies and agriculture land management plans would become integrated for private sector investment decision-makers. Once robust demand for environmental benefits is demonstrated, farmers could become less dependent on government for conservation payments and the government’s Conservation Security budget could be stretched farther.

Caution
One correspondent has asked us: "Why don't we just encourage the US government to pay that farmer $25,000 for Tier 1 practices and leave marketable title to AG-CERCs with the farmer?" The answer is that such a strategy would kill likely any long run private sector demand for agriculture sector-generated AG-CERCs or green tags. The critics of the energy sector’s early efforts to develop a GHG offset/ERC market often accuse the energy sector taking credit for environmental improvements that would have happened anyway (sometimes--but not as often as the opponents to emissions trading would suggest--the criticism is justified). It is not likely that careful energy companies will buy AG-CERCs deriving from practices that the taxpayer has already financed, for fear of drawing increased criticism and putting wide stakeholder support for emissions trading in greater jeopardy. Also, in the face of such a proposal, it would be quite reasonable for the electricity generators (more importantly, their customers) to demand a comparable government subsidy for the implementation of similarly environmentally superior operations management practices in their own sectors. This is a potentially very costly path, we would guess, that government does not want to start down.
Integrating Bill S932 with Bills S765 and S7699

One of the best reasons to consider isolating and separately pricing the carbon sequestration potential of actions taken under Conservation Security Contracts is because it is not difficult to imagine, in so doing, how to then ensure that the Harkin bill and the Brownback bills (or possible future bills modeled after the Brownbacks) could be made complementary, as opposed to in conflict.

Recommendations #7 through, #11

- The value assigned to carbon sequestered by the Conservation Security program should be equal to the value of the investment tax credit outlined in bill S765. Right now the Brownback bill to amend the Internal Revenue Code of 1986 to provide a carbon sequestration investment tax credit proposes a tax credit of $2.50/tC, which is roughly $0.67 tCO2e...a little lower than the current market spot market price for agriculture-sector generating AG-CERCs. This appears an appropriate price if it is the intent of government to set a floor price, but not lead the market for very (a strategy GEMCo would endorse).

- To ensure a fungible commodity, the implementing panel of the International Carbon Conservation Act (S769) should ensure that participants in qualified carbon sequestration project would be issued AG-CERCs that are fungible with domestic AG-CERCs that are certified through the Conservation Security contracting process.

- To claim the investment tax credit, the farm corporation should be required to retire AG-CERC certificates at the time of tax filing.

- The DoA should retain the unfettered right to use, resell, retire, auction or otherwise dispose of any AG-CERCs title to which are transferred to the DoA through an investment tax credit claim.

- Flow-through provisions should apply to the investment tax credits. In other words, should an energy company indirectly finance the adoption of sustainable agriculture practices in a developing through an arrangement with a US-based agriculture corporation, and should the US-based agriculture corporation agree to transfer earned investment tax credits to the energy company, the agriculture corporation would keep its commitments by transferring International Carbon Conservation AG-CERCs to the energy company. The energy company could then: (1) claim the investment tax credit, or (2) sell the AG-CERC into a secondary market, or (3) retire the AG-CERC under any state-sanctioned GHG offset program, etc.

If the flow-through provisions are not associated with the investment tax credit, the only beneficiaries of Bill S769 will be large agri-business. The flow-through provisions result in wider range of financing options that open the door for smaller specialty farm businesses to export expertise to developing nations. Unfortunately, some of the farm corporations technically well-positioned to gain most from programs like these are somewhat inclined to be short of U.S. taxable income for years to come. Carry forward provisions do not do the trick for enterprises for which taxable profits appear to be some years out. But if smaller farm corporations or cooperatives, including not-for-profit enterprises, have the option of selling AG-CERCs (which is the same as selling the investment tax credit) to energy companies, a more
robust private market demand for AG-CERCs could evolve, the bottom line of non-tax-paying agriculture enterprises will improve faster, and the day they start paying taxes in the US arrives sooner.

Key Questions

*Harkin bill and AG-CERC trading, problem raised: how do you distinguish between new adopters of sustainable practices and those that are already engaged in BMPs? Should you?*

Some of our correspondents have expressed the view that one of the principal benefits of the Harkin bill is that farmers that adopted Best Management Practices (BMPs) in the past will access Conservation Security program payments. You have asked how Carbon Emission Reduction Credits (AG-CERCs) could be incorporated in a CRP/CSP that does not discriminate between existing and new adopters of BMPs. The assumption is that tradable AG-CERCs should only be generated by new adopters of BMPs.

This is a very good question, and the answer is a matter of opinion. Should the right to generate tradable AG-CERCs be restricted to new adopters of BMPs or should it be open to all practitioners? For GHG reductions originating in many other sectors, GEMCo would be the first to agree that ERCs should not be associated with activities that are already underway. But we do not feel the argument stands in regard to agriculture sector-generated AG-CERCs.

We do not have any US data, but in Canada, for the past three years we have lost more acres from the national pool of land under BMPs than we have added. So, it seems that keeping practitioners committed to maintaining BMPs is as important as adding new practitioners to the pool. So, in this one case, we would argue that to write an AG-CERC creation rule that distinguishes between acres currently in the BMP pool and newly added acres is unnecessary.

We understand that this argument might sound to some like energy companies wanting to create the opportunity to establish "anyway" credits for "anyway" tons. If legislators find they cannot agree with our perspective, they might consider a second option. This would involve the establishment of two classes of soil carbon AG-CERCs. The first class is assigned to acres that have been in the BMP pool for some time (say, since 1999) and the second class is for new adopters (say, after January 1, 2000). There is a restriction on the first class that prevents these AG-CERCs from being retired by anyone other than the entity to which they are first issued. This is, in effect, a restriction from trading these AG-CERCs. The second class of AG-CERCs could be free of trading restrictions.

Farmers with acres already under BMPs would be able to retire title of the Class One AG-CERCs to government, either to maximize their payment under the provisions of the Conservation Security program or to claim an investment tax credit under S765. Only Class Two AG-CERCs could be flowed through to a third party, or to be applied against a legislation-based obligation to cap GHG emissions, or to justify the issuance of a "green tag", etc.

*AG-CERC trading, question: why would you not also isolate water benefits in the Conservation Security contracts and declare them tradable in a manner consistent with AG-CERCs?*

Another correspondent asked why we have only recommended the recognition of AG-CERCs and did not add in other tradable instruments. The idea is that a US domestic market for water quality credits
could be emerging as fast or faster than the market for GHG/carbon offsets, and that BMP impacts on water quality are larger than the BMP impacts on GHG concentrations in the atmosphere. Our first response is "great". It was not our intention to limit the scope of thinking here. We do not think the list of environmental "credits" needs to be finalized in order to pass these bills into law. What needs to be agreed that the general principal of environmental credit trading could apply broadly, that investment tax credits and compliance credits for one class of investment should be fungible, and that credits for international investments should be fungible with credits for comparable domestic investments.

Our delayed response is also "have realistic expectations". While the demand and forecast market price for agriculture sector water quality credits might be, in theory, much higher than the demand and forecast market price for AG-CERCs, it is also still true that the largest water users are the agriculture sector and municipal governments. So, payments for water quality credits might, for some time, represent transfers within the (financially stressed) agriculture sector and between agriculture and municipal service (taxpayer funded not-for-profit) organizations. Payments for AG-CERCs could come, disproportionately, from profitable investor-owned organizations. These may or may not be important short term considerations for the federal policy maker.