National Cap-and-Trade Legislation Passes the House: At 1,428 Pages, Nearly Something for Everyone

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written by Seth D. Jaffe, Adam P. Kahn, Amy E. Boyd

The narrow passage by the House of Representatives of H.R. 2454, the American Clean Energy and Security Act of 2009 [.pdf], by a vote of 219-212 on Friday, June 26, marks the first time that major legislation on global warming has passed either house of Congress. The Bill, which is 1,428 pages long, includes many key concepts from the draft introduced by Representatives Henry Waxman and Edward Markey in May, as well as a number of revisions and additions that ensured its passage.

Attention now turns to the Senate, which, according to statements by key committee members and Obama Administration officials, will likely not reach a vote on global warming legislation until this fall, at the earliest. Should the Bill fail to pass in the Senate, greenhouse gas emissions may still be regulated through other methods, such as state and regional climate change initiatives and possibly direct regulation by the EPA through the Clean Air Act, under its endangerment finding.

In a nutshell, the Bill contains the following provisions:

1) **Clean Energy**: promotes renewable energy through a federal renewable electricity standard (20% by 2020) that includes efficiency, renewable biomass and hydropower built since 1988; authorizes federal agencies to enter into long-term contracts with renewable energy providers; crates a national strategy for the commercial deployment of carbon capture and sequestration (CCS) technologies; provides funding for construction of plug-in electric automobile battery manufacturing facilities; provides additional funds to state renewable energy and efficiency programs (SEED); and gives the Federal Energy Regulatory Commission backstop authority to site interstate transmission lines in the West if states fail to act on proposals.

2) **Energy Efficiency:** calls for a nationwide building efficiency code; provides additional funds for State Energy Programs to create a number of energy efficiency programs; creates a Clean Energy Manufacturing Revolving Loan Fund Program and Clean Energy and Efficiency Manufacturing Partnerships program; and establishes programs through the U.S. Department of Housing and Urban Development (HUD) that promote energy efficiency and renewable energy in affordable housing.

3) **Reducing Global Warming Pollution:** finds that global warming poses a significant threat to the national security, economy, public health and welfare and environment of the United States and other nations, and sets out a schedule for reductions in greenhouse gases from 2005 levels of 17% by 2020 to 83% by 2050. The cuts are to be achieved through a

cap-and-trade program that covers large sources collectively responsible for approximately 85% of US emissions. The program would begin by allocating for free most of the 4.6 billion allowances issued in 2012, and allows compliance via the use of up to 2 billion domestic and international offsets per year, including offsets created from agriculture and forestry programs. A provision, present in the initial discussion draft circulated in April, which would have added a citizen suit clause to the Clean Air Act was removed before final passage.

4) **Transitioning to a Clean Energy Economy:** establishes a number of projects and funds for green jobs training programs; establishes rebates for certain energy-intensive industrial sectors (to ensure international competitiveness); provides consumer assistance in the form of energy tax credits; creates a new council within NOAA to prepare a National Climate Change Adaptation Program; and funds state programs to increase resilience against extreme weather events and air pollution.

5) **Agriculture and Forestry Related Offsets**: added as a key last-minute concession to farm states; provides a number of programs for agriculture-related offsets to be administered by the US Department of Agriculture.

Future alerts will provide additional details regarding the Clean Energy and Energy Efficiency titles. The remainder of this alert focuses on the Reducing Global Warming Pollution title.

Focus on Cap-and-Trade:

The central element of the Bill's Global Warming title is an economy-wide cap-and-trade program which is set to commence in 2012. The total number of available allowances ratchets down each year – decreasing from a 2012 level of 4.6 billion allowances (3% below 2005 emission levels) to just over one billion allowances (83% below 2005 emissions) in 2050, the level at which the cap remains into the future. Power plants, oil refineries, natural gas distribution companies, geological sequestration sites, certain industrial sources, and other large industrial sources that emit more than 25,000 tons of CO_{2e} annually would be considered "covered entities" subject to the cap. These sources, similar to the list included in EPA's proposed greenhouse gas reporting regulations [.pdf], are collectively responsible for 85% of US greenhouse gas emissions. That figure that is determined by accounting for the covered entities' direct emissions as well as indirect emissions, such as the amount of CO_2 produced by downstream users of fuels like gasoline.

Beginning in 2013, the first tier of sectors to be phased-in to the program (power plants and fuel producers) must surrender every April 1st an allowance for every ton of CO_{2e} emitted the previous year, or pay a penalty equal to twice the market value of the missing allowances, in addition to offsetting the additional emissions within the next year.

How to Get Allowances:

Although the Bill establishes a framework for quarterly auctions of allowances, most covered entities will get their allowances through direct allocation, at least for the first 18 years of the program. The allocation structure has been the subject of intense political lobbying and debate and may change as the bill is considered by the Senate.

The Bill requires that the bulk of allowances – the 43.75% to be allocated to electric utilities and 9% to be allocated to natural gas distribution companies – be used for the benefit of retail ratepayers, in an attempt to keep electricity prices affordable. A forecast of the impact on ratepayers issued by MJ Bradley & Associates [.pdf] estimates that monthly electricity bills would increase less than $6 due to the Bill, with the Northeast, California and other areas that have the highest electricity prices having the smallest rise in prices, or even seeing decreases in their bills.

Other allocations in the Bill are designed to benefit power generators. Merchant coal generators could be allocated up to 4% of the total allowances in 2012, and generators with long-term power purchase agreements commencing before 2007 could receive free allowances for all of their previous year's emissions that are attributable to long-term agreements, so long as the generator meets certain criteria.

The legislation also seeks to protect energy intensive industries from foreign competition that is not subject to climate change regulations. Beginning in 2014, certain industrial segments could receive up to 15% of the total allowances, which may be allocated to industries that can prove they are energy intensive and exposed to international competition.

However, the allocation structure does not mirror expected emissions. Although oil refineries would receive 2% of all allowances issued in 2014, the first year they are subject to requirements, the refineries will still need to acquire nearly 40% of all available allowances to cover not only direct emissions at refineries but also the carbon dioxide produced when fuels are burned by cars and trucks downstream.

Although many of the allowances will be allocated for free, at least initially, the program will, particularly over time, generate substantial revenue. The Bill contains a provision which would send proceeds from the 2012-2025 allowance auctions into a Treasury fund for deficit reduction. Starting in 2026, proceeds from the quarterly auctions of allowances that are not already allocated will go into a fund providing tax refunds on a per capita basis to each household.

Offsets:

In addition to obtaining allowances, covered entities will be able to meet the cap using offsets. The use of offsets under the is restricted to roughly 2 billion allowances a year, an amount that is in addition to the 4.6 billion allowances issued in 2012, and remains relatively constant while the number of allowances decreases sharply to just over one billion by 2050. Given that offsets could essentially triple the amount of emissions allowed in 2050, offsets that will qualify under the Bill are likely to be in demand. Some commentators question whether the US and international markets can create and verify 2 billion allowances a year. For sake of comparison, the UNFCCC predicts that the 4,200 projects pending under the Clean Development Mechanism program will have created 2.9 billion offsets *total* from 2006 to 2012.

Significant changes to the offset provisions were made just hours before the Bill's passage. Notably, "term offset credits" were added, allowing regulated entities to demonstrate compliance via offsets that provide short-term emission reductions, rather than requiring the permanent and verifiable type usually mandatory for offsets. Term offset credits may function to buy covered entities time, but are not without cost. Covered entities that use term offset credits will be required to post financial assurance when they use the credits and acquire either allowances, permanent offsets, or additional term offset credits prior to the date on which the term offset credits expire. Although term offset credits raise questions, particularly regarding permanence and additionality, they could allow an interim form of compliance while offset programs ramp up and permanent offsets work their way through the time-consuming verification process. Another significant last-minute change was the addition of Title V to the Bill, which lists a number of activities that will qualify for agricultural and forestry offsets, all of which will fall under the jurisdiction of the US Department of Agriculture, rather than the EPA, which will oversee all other offset programs.

Reserve Price:

Another notable provision of the Bill is the allowance reserve price. The Bill sets a reserve auction price for 2012 of $10 in 2009 dollars, to be increased by 5% plus the rate of inflation for auctions in subsequent years. Even without inflation, this escalating floor means allowance prices in 2030 will be at least $24 each, rising to $64 each in 2050. Given that offsets will be preferentially chosen once allowance prices rise, this reserve auction price could also ensure that the 2 billion annual offsets allowed under the Bill generate upwards of $50 billion for offset project sponsors by 2030. Given the expansive list of agriculture and forestry offsets that were added to the Bill in the hours before it was passed, investment in projects such as manure management and disposal, urban tree planting, and reduction in the frequency and duration of flooding of rice paddies could be lucrative investments in the years to come.

Preemption:

The Bill preempts the body of state, regional and EPA programs that have been established in the absence of national carbon legislation and will likely persist if the Bill does not pass the Senate. It explicitly preempts state and regional cap-and-trade programs between 2012 and 2017. Given that RGGI was scheduled to end in 2018 and the Western Climate Initiative's was scheduled to begin in 2012, this timetable effectively eliminates these nascent cap-and-trade programs. However, given the specific definition of cap-and-trade included in the Bill, a question remains as to whether states may pursue reductions in CO_2 in other ways, such as a fuels standard or carbon tax. The Bill also prevents EPA from imposing additional greenhouse gas regulations by specifying that CO_2 and other greenhouse gases may not be regulated as criteria air pollutants or hazardous air pollutants, nor would they apply to New Source Review under the Clean Air Act.