

February 5, 2013

**Practice Groups:***Climate Change and Sustainability**Energy*

## Potential Linkage between Californian and Australian Greenhouse Gas Cap-and-Trade Regimes

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Australia and the State of California are investigating opportunities for linking their carbon pricing and greenhouse gas (“GHG”) cap-and-trade programs. On January 15, 2013, officials from the Australian Parliament and the California state government, including the Honorable Mark Dreyfus, Australian Parliamentary Secretary for Climate Change and Energy Efficiency, Mary Nichols, Chairman of the California Air Resources Board (“CARB”), and representatives from the California Environmental Protection Agency, met at the Davis campus of the University of California for discussions regarding carbon pricing and GHG cap-and-trade markets. Although the discussions were preliminary, and no specific plans for linkage have been formulated yet, representatives from both sides expressed considerable enthusiasm for pursuing further discussions. A linkage of the California and Australia cap-and-trade programs could increase liquidity in both carbon markets by providing market participants with additional trading options, and would be likely to cause price convergence between the two programs.

### California’s Cap-and-Trade Program

California’s long-awaited GHG cap-and-trade program was mandated as part of California’s landmark Assembly Bill 32, the Global Warming Solutions Act of 2006, generally known as “AB32.” AB32 establishes a cap on annual emissions of companies covered by the program and mandates that each covered entity have qualifying compliance instruments for every metric ton of CO<sub>2</sub> emitted per year (“tCO<sub>2</sub>-e/pa”). AB32 requires that GHG emissions in California be reduced to 1990 levels (427 million tCO<sub>2</sub>-e/pa (“mtCO<sub>2</sub>-e/pa”)) by 2020 (which represents a reduction of 80 mtCO<sub>2</sub>-e/pa), and the state has announced plans to reduce emissions to 20% below 1990 levels by 2050. In accordance with AB32, CARB adopted final regulations instituting a GHG cap-and-trade program in October 2011. Those regulations were revised in new final regulations that were issued in September 2012. The final regulations issued in September 2012 provide, among other things, for a formal linkage between California’s GHG cap-and-trade program and a similar GHG cap-and-trade program in the Canadian province of Quebec.

California’s cap-and-trade program limits emissions of 360 businesses representing 600 facilities that individually emit 25,000 or more tCO<sub>2</sub>-e/pa and that collectively are responsible for 85% of California’s GHG emissions. The limitations on GHG emissions are imposed in two phases: (i) in January 2013, limitations on the GHG emissions of major industrial sources and electric utilities came into effect; and (ii) in 2015 distributors of transportation fuels, natural gas and other fuels will also become subject to the regulations. CARB held its first auction of GHG emissions allowances on November 14, 2012. In the auction, CARB offered for sale 10% of the allowances in both the 2013-2014 vintage allowance class and the 2015-2017 vintage allowance class. All of the 2013-2014

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vintage allowances offered for sale in the auction— 3,126,110 allowances, each representing one tCO<sub>2</sub>-e/pa—were purchased. For purposes of the auction, CARB ranks bids in order from highest price bid to lowest, and then allocates allowances to bidders starting with the highest bidder until all available allowances have been allocated. All selected bidders pay the same settlement price, which is the lowest bid price to which any allowances are allocated as a result of CARB's bid ranking process. The initial auction resulted in a settlement price of US\$10.09 per allowance, an amount US\$0.09 above the auction reserve price stipulated in the CARB regulations for the first auction. Of the 2013-2014 vintage allowances that were sold, 97% were purchased by "covered entities," meaning entities that are subject to mandatory limitations on GHG emissions. Additionally, 5,576,000 of the 39,450,000 2015-2017 vintage allowances offered for sale were sold, at a settlement price equal to the reserve price of US\$10.00 per allowance. The next quarterly auction will be held on Tuesday, February 19, 2013. In the meantime, markets are open for secondary trading of emissions allowances on the Compliance Instrument Tracking System Service, the market tracking system for the California cap-and-trade program.

A linkage between the Australia and California carbon markets might present legal uncertainties that are not presented by the proposed linkage of the California and Quebec cap-and-trade markets. The U.S. Constitution gives the federal government full and exclusive responsibility and control over the foreign relations of the United States, and prohibits state and local governments from engaging in a wide range of activities involving foreign affairs. Nevertheless, state and local governments are permitted, without the consent of Congress or the Executive Branch of the federal government, to make certain kinds of agreements with foreign governments and subdivisions of those governments. It is unclear whether the proposed linkage between the Australia and California GHG cap-and-trade regimes would be deemed to fall within the scope of that state authority.

Various parties, including several environmental groups and the California Chamber of Commerce, have filed lawsuits challenging the validity of various aspects of CARB's cap-and-trade program. The litigation filed by the Chamber of Commerce is regarded as the most serious legal challenge to the program so far. The Chamber's Petition for Writ of Mandate and Complaint for Declaratory Relief alleges that CARB exceeded its authority under AB32 by allocating emissions allowances to itself and retaining the proceeds from the sale of those allowances in the cap-and-trade auction process. The collection of those proceeds, the Chamber alleges, constitutes an unconstitutional tax because it was imposed without the requisite approval by two-thirds of the members of the state legislature.

### Australia's Carbon Pricing Mechanism

Under the Clean Energy Act 2011 (Cth), Australia introduced a "carbon pricing mechanism," which commenced on July 1, 2012. The objective is to reduce Australia's emissions to 5% below 2000 levels (528 mtCO<sub>2</sub>-e/pa) by 2020 (which represents a reduction in emissions of 28 mtCO<sub>2</sub>-e/pa). While this seems a low target, it is set in the context of Australia's growing population and booming energy export industry. Australia has also adopted an aspirational target of 80% reduction below 2000 levels by 2050 (which represents a reduction of 444.8 mtCO<sub>2</sub>-e/pa). Australia's carbon pricing mechanism limits the GHG emissions of 330 liable entities that are collectively responsible for 60% of Australia's GHG emissions, or 330 mtCO<sub>2</sub>-e/pa. In size, it is therefore similar to the California program, which covers 360 entities that are collectively responsible for 85% of California's GHG emissions, or approximately 395 mtCO<sub>2</sub>-e/pa. Liable entities are entities in the following sectors that have attributable emissions in excess of 25,000 tCO<sub>2</sub>-e/pa: electricity generation, gas retailers, gas, coal and fuel producers (for emissions attributable to the production process) and large users of such fuels, off-road heavy goods vehicles, and waste and fugitive emissions.

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For the first three years of the mechanism (July 1, 2012-June 30, 2015), liable entities must purchase and surrender fixed price carbon units attributable to the GHG emissions for which they are responsible. The fixed price carbon units are purchased from the Clean Energy Regulator and the number of such units is uncapped. Liable entities basically write the regulator a check for their GHG emissions at the rate of AUS\$23 per tCO<sub>2</sub>-e/pa.

From July 1, 2015 the mechanism becomes a cap-and-trade scheme under which liable entities must purchase and surrender market priced units equal to the GHG emissions for which they are responsible. The mechanism allows acquittal of liability by the surrender of (1) Australian carbon units purchased under a descending clock auction from the Clean Energy Regulator, (2) Australian carbon offset units created by activities that sequester, avoid or abate emissions and are certified by the Clean Energy Regulator as being “Kyoto compliant” activities, (3) international units (limited to 50%) which can be used under the Kyoto Protocol for acquitting liability and (4) European allowance units (limited to 12.5% and, when aggregated with the international units, limited to 50%) which can be surrendered to acquit liability under the European Union Emissions Trading Scheme.

From July 1, 2015 the prices of Australian carbon units and Australian carbon offset units are expected to be similar to and track the European allowance unit trading price, which is currently around 4 Euros or US\$5.40. If the California program links with the Australian mechanism from July 1, 2015 we would expect the price of California allowances to similarly track the Australian/European price. On current rates this represents a 50% reduction in the California price.

The Australian mechanism is, however, under threat of repeal following the next election in Australia on September 14, 2013. The leader of the opposition party (the Liberals), Tony Abbott, has consistently stated that if the Liberals are elected the first thing they will do will be to repeal the carbon pricing mechanism. In its place they will encourage direct action by paying for GHG emissions reductions via a tender process including measures such as sequestration of carbon in soil. The polls currently give the Liberals a strong chance of winning the election. This prospect creates huge uncertainty regarding the future of Australia’s carbon pricing mechanism, and by extension for the ongoing discussions between Australia and California as to linkage between their respective carbon pricing or cap-and-trade markets.

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