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CLIMATE CHANGE

CAP-AND-TRADE

The 45-day public comment period began Nov. 1 for proposed regulations by the California Air Resources Board to implement a landmark cap-and-trade program for greenhouse gas emissions. California's proposal, which ''has the ambition to lead towards a national and international cap-and-trade program,'' appears to have been bolstered by recent election results in California, say attorneys Peter Hsiao, William M. Sloan, and Michael J. Steel in this BNA Insight. The authors describe the proposed cap-and-trade program, and analyze its key elements.

California Continues to Blaze New Trail on Climate Change Cap-and-Trade Policy

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In the midst of a contentious political debate about climate change and the economy, the California Air Resources Board (CARB) issued its draft regulations to implement the centerpiece of the state's Global Warming Solutions Act (AB 32), a landmark cap-and-trade program for greenhouse gas (GHG) emissions. While there are other, smaller cap-and-trade programs in the United States, California's proposal will cover approximately 85% of the state's total GHG emissions and has the ambition to lead towards a national and international cap-and-trade program.

CARB's regulations have already survived two significant challenges as a result of the recent mid-term

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elections. First, the state's voters rejected a ballot proposition that would have delayed the implementation of the regulations until the state's unemployment rate fell to 5.5 percent for four consecutive quarters. Second, the voters elected Jerry Brown, a staunch proponent of AB 32, to repeat his service as governor. Sen. Barbara Boxer, the head of the Senate Environment and Public Works Committee, was also reelected.

California's political interaction with cap-and-trade can be compared with that in New Mexico, a partner with California in the Western Climate Initiative, an association of western states and Canadian provinces that have worked together to develop a coordinated cap-and-trade program. The New Mexico Environmental Improvement Board, also narrowly approved a similar cap-and-trade program on November 2, 2010. As with California's program, New Mexico will require approximately 63 major emitters to start cutting emissions by two percent per year below 2010 levels, beginning in 2012. However, the state's new governor-elect, Susana Martinez, has stated her strong opposition to the cap-and-trade program and her intention to delay or repeal it upon taking office in January 2011.

California's election results served as a critical bulwark for advocates of immediate action to address climate change. After the success of congressional candidates who campaigned on platforms opposing a national cap-and-trade program, many observers predict only incremental further progress will be made on federal energy legislation, and no further progress on federal climate legislation. Perhaps reflecting these dim prospects for further progress, EPA recently announced that Lisa Heinzerling, the head of its policy office and one of the primary architects of its climate change programs, will leave EPA to return to her teaching position at Georgetown University.

Thus California, which comprises the world's seventh largest economy, proceeds as a powerful leading force for the nation towards a cap-and trade program. The result, even absent a federal program, will be an important market signal to set a precedent for placing a national price on carbon. The details of CARB's program are set forth in its proposed regulations, which will be the subject of intense scrutiny and public comment.

Background and Scope of CARB's Cap-and-Trade Program

A cap-and-trade program sets a fixed limit on emissions from major sources (the ''cap'') and reduces those emissions by gradually lowering the aggregate cap each year. The state issues allowances to emitters during the first year of the program, and the emitters are allowed to purchase and sell those allowances, and offset credits, at auction or from others (the ''trade''). Cap-and-trade is intended as a flexible market-based mechanism to reduce GHG emissions. It is a key component of AB 32, which requires the state to reduce overall emissions to 1990 levels by 2020 (approximately a 29% reduction).

California proposes to impose a declining cap on aggregate emissions by covered industries starting in 2012. The cap will initially be set at the estimated 2012 level of emissions with a specified number of ''allowances,'' which each represent one metric ton of carbon dioxide or its equivalent in other GHGs (commonly referred to as ''$MTCO_2e$''). At the end of each compliance period, emitters must surrender allowances and/or ''offset credits'' in an amount equal to their GHG emissions during that period. The state would then permanently retire the surrendered allowances, and issue a new, reduced set of allowances for the following compliance period.

Who Is Covered?

The regulation covers four categories of parties: covered entities, opt-in covered entities, voluntarily associated entities, and other registered participants. Starting in 2012, the first phase of ''covered entities'' includes the electricity generation sector and large industrial sources with GHG emissions at or above 25,000 $MTCO_2e$. In 2015, the second phase of the program would expand to include providers of transportation fuels and residential and commercial fuels, with additional phases to follow in later years. Parties, including those that do not exceed the 25,000 $MTCO_2e$ threshold, can also voluntarily opt-in to the program.

To create a trading market, the program is also open to voluntarily associated entities including the general public, investment banks, and private citizens or groups that would be allowed to hold allowances and offsets, and would be subject to registration and reporting requirements. The final category of covered parties is ''registered'' participants which include private or government organizations that will verify the legitimacy of the allowances or credits, the offsets, and the banking mechanisms.

How a Regulated Entity Obtains Its Allowance

CARB proposes to distribute the allowances through a combination of free allocation, sale at auction, and an Allowance Price Containment Reserve. Allowances will initially be allocated for free to the industrial sector for two reasons: (1) to avoid sudden or undue short-term economic impacts and promote a transition to a low-carbon economy, and (2) to prevent ''leakage,'' where California facilities are disadvantaged, and production shifts outside of California, resulting in unchanged or increased GHG emissions. Initially, the allowances will be set at about 90 percent of the average emissions, based on an efficiency benchmark for each industry that will be updated annually.

Additionally, allowances will be allocated for free to electrical distribution utilities. The utilities must use the benefit from the allowances so that electricity ratepayers do not experience sudden increases in their electricity bills as a result of the regulation. Utilities could do this through rebates, customer bill relief, or paying for GHG-reducing measures. The remainder of allowances will be sold at quarterly auctions, which CARB believes is the most fair and transparent means of distribution.

CARB's decision to initially distribute the allowances through a free allocation is a clear signal that the agency is concerned with the burden of additional costs from the cap-and-trade program on the state's economy. Prior estimates of windfall revenues to the government from the auction of credits have been placed aside in the draft regulations in favor of quick implementation of the program with a lessened burden on the regulated emitters.

The regulation proposes to create an Allowance Price Containment Reserve, to expand flexibility and reduce compliance costs. Covered entities will be able to purchase allowances from the Reserve at fixed prices three weeks after each quarterly auction, which will limit increases in the market price as it approaches the fixed Reserve price. The Reserve will consist of (1) a portion of allowances from each budget year, (2) CARB allowances that are not sold at auction, and (3) allowances surrendered to comply with excess emissions provisions. The Reserve will vary from one to five percent of total allowances in the program from 2012 through 2020.

Entities subject to the GHG cap would be required to meet compliance obligations through surrender of allowances and/or offset credits. If the allowances initially allocated to a particular source are not sufficient to cover that source's GHG emissions, then it will be required to obtain offset credits, or purchase more allowances from other entities with allowance surpluses, or both.

Use of Offsets

Up to eight percent of a regulated party's allowances may be comprised of offset credits. Offsets are obtained from certified parties not subject to the regulated cap, such as reforestation projects, urban forest projects, livestock manure (methane management) projects, and removal of ozone-depleting substances. Providers of offset credits would be required to register with CARB or an approved offset protocol registry, and to publicly list these projects. In total, the current proposal would allow for up to 232 million $MTCO_2e$ worth of offsets to be used through the year 2020. The amount of offsets that the agency allows for compliance purposes plays an important role in controlling the cost of compliance—the more that are available, the lower the cost.

Banking of Allowances

CARB's proposed regulations would also allow covered entities to ''bank'' allowances—without restriction—for use in later compliance periods. CARB believes that this approach will encourage industries to adopt early emission-reduction strategies in order to avoid increased compliance costs as the emissions cap is reduced over time.

Compliance and Enforcement

The proposed regulation includes three-year compliance periods with the first period commencing on January 1, 2012. Covered entities are subject to an annual compliance obligation and will surrender allowances/offsets equal to 30 percent of the previous year's emissions. At the end of each compliance period, covered entities will surrender the remaining allowances, which will be permanently retired by CARB.

The proposed regulations require covered entities to register and create an account with CARB or a designated account administrator. The California Cap-and-Trade Market Tracking System would track allowances and offsets as well as submittals and transactions. Under the proposed regulations, entities that do not surrender the appropriate number of allowances or offsets will be subject to CARB enforcement and penalties. The regulations define each day that each allowance or offset has not been surrendered as a separate violation.

Non-covered businesses and private individuals will be indirectly affected by increases in the cost of fossil-fuel energy as companies pass the cost of compliance to consumers. CARB expects the proposed regulations to create jobs in renewable energy sectors in California.

Public Comment Period

CARB has set a 45-day public comment period for the Proposed Regulations starting Nov. 1, 2010, and ending Dec. 15, 2010. CARB will hold a public meeting to consider the comments on Dec. 16, 2010. Following the meeting, CARB will review and incorporate any changes and will make proposed changes available for public comment in the summer of 2011.

The recent public debate over the ballot initiative to delay the implementation of the proposed regulations portends at least two other consequences. First, the proponents of climate change regulation, including California's governor-elect, will look to the voter rejection of the California initiative for delay as a mandate that the regulations proceed to implementation in January 2012.

Second, the debate called into question whether a global problem should or could be addressed by one state, even one with an economy as large as California, where the state emission controls are unlikely to materially affect the world's total emission of greenhouse gases. The voters' decision to move forward suggests an understanding of the importance of a California initiative to set precedent for the future energy policy of the nation and the climate control efforts of the world. It is especially notable as an unexpected example of ''states' rights'' in a larger national debate about devolving regulation from the federal government to the states.