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California Air Resources Board Adopts Cap-and-Trade Program Regulations for Greenhouse Gases

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On Oct. 20, the California Air Resources Board (CARB) adopted the final regulations to implement a cap-and-trade program for greenhouse gas (GHG) emissions. Upon approval by the Office of Administrative Law, the regulations will take effect on Jan. 1, 2012. The obligation to surrender allowances under the program, however, will not begin to accrue until Jan. 1, 2013. This first phase of the cap-and-trade program includes California electric generation facilities, electric utilities, large industrial facilities which emit 25,000 tons or more of GHGs, and those who import power from out of state into California.

The California Global Warming Solutions Act of 2006 (AB 32) requires California to reduce overall emissions to 1990 levels by 2020. The cap-and-trade program is targeted to capture 18% of the reductions needed to meet the goals of AB 32. CARB is promoting this cap-and-trade program as one part of its overall program to reduce GHG emissions. Under AB 32, CARB has previously implemented through regulation several other major measures including standards for low carbon fuels and ultra-clean cars.

The cap-and-trade program is significant as the first program in the country addressing GHG emissions across industry lines. In general terms, a cap-and trade program applies a limit on the amount of GHG emissions and that cap declines over time, while instituting an allowance distribution and trading market that will allow emitters to buy, sell, and trade allowances to emit GHGs. In theory, each emitter will make decisions about the amount of GHGs it will emit, based on the cost and availability of emissions-reducing technology and allowances. The California program is designed to link with other trading programs in Canada and eventually in other states and federal programs in the United States.

The first phase of the program includes as “covered entities” electric utilities and large industrial facilities which emit 25,000 tons or more of carbon dioxide or its equivalent in other GHGs (“metric ton equivalents,” or “$MTCO_2e$”) annually. The industrial sources covered include petroleum refiners, manufacturers of cement, iron, steel, glass, lime, and paper and suppliers of natural gas and other fuels. Also, importers of electricity will be required to participate in the first phase of the program. In 2014, the classes of covered entities will expand to include distributors of transportation, natural gas, and other fuels.

The number of allowances for each industrial sector in the first phase will be set at about 90 percent of the average emissions, thus rewarding the lower emitters. Allowances will initially be given away to the electric utilities though CARB has directed that revenues realized through the sale of the allowances inure to the benefit of the ratepayers. CARB has not (because it cannot) direct how that will occur. Currently, the Public Utilities Commission is grappling with that concept (Rulemaking (R.) 11-03-012) and holding a public workshop on it Nov. 1-2, 2011. Allowances can be traded and CARB has solicited offers from trading companies to establish a system for doing so. CARB expects to select the company to do the development work by Jan. 2012. The first auctions are scheduled for Aug. and Nov. of 2012. The regulations provide controls for prices and allow banking and reserves to attempt to smooth out fluctuations and monitor abuses.

Covered entities will need to turn in allowances or use offsets (up to 8% of their compliance obligations) equal to the $MTCO_2e$ of their GHG emissions. However, any offsets must meet the CARB requirements that the offsets represent real, verifiable, and additional reductions in emissions. Currently, CARB is only

recognizing four approved protocols for offsets: forestry, urban forestry, dairy digesters, and destruction of ozone-depleting substances. CARB will monitor to determine if emissions reductions associated with offset credits have been overstated.

Although the California cap-and-trade program goes into effect in 2012, the compliance obligation (surrendering the allowances) begins Jan. 1, 2013. During 2012, the provisions regarding allowance allocation, auctioning, and trading will begin but none of the emissions in 2012 will require allowances to be turned in. Emissions during 2013 will require allowances (a portion of which must be turned in by Nov. 1, 2014). Covered entities will begin turning in allowances related to the prior year's emissions. The program has a rolling three year compliance cycle and each year an entity must surrender at least 30% of the allowances required for the prior year's emissions. This system is designed to reduce price spikes and shortfalls in the market. Thus, each year on Nov. 1, a covered entity must turn in allowances for at least 30% of its prior year's emissions, and after three years, it must turn in all remaining allowances required over that three-year period. (The first compliance cycle is only two years, 2013-2014, but subsequent cycles will be three years.)

CARB will be receiving input on this program and will closely monitor the potential for unintended economic or environmental consequences. On Oct. 10, 2011, CARB announced an Adaptive Management Plan to monitor the effect of the program on localized air quality and forests, in particular. This plan will require CARB to work with the local air districts which regulate emissions from stationary sources.

2012 and Beyond

Many questions remain about the program: how past reductions achieved through "early action" will be treated; how allowances will be allotted and auctioned over time; whether disparate impacts between Northern California and Southern California resources will result. Litigation challenging aspects of CARB's program is to be expected (and current litigation about AB 32 and the cap-and-trade program in particular will continue).

Covered entities need to register and create an account with CARB or its appointed service company and will need to develop a plan for obtaining and tracking allowances and/or reducing emissions. When distributors of transportation fuels are included in 2014, increased fuel costs may have a substantial ripple effect on other businesses not currently considering cap-and-trade compliance. On the offset front, businesses which engage in activities associated with potential offsets should consider qualifying as a CARB-approved protocol.

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