

Are There Lessons to Be Learned From California's Proposed Cap-and-Trade Program?

by Tom Munteer

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The U.S. Senate's inability to pass climate change legislation does not arise from its inability to nail down the particulars of a greenhouse gas (GHG) emission cap-and-trade program. While GHG cap-and-trade programs have been the centerpiece of congressional bills for a number of years, disagreement on the mechanics of such a program is not what has led to legislative stalemate. Rather the stalemate stems from: (1) the potential effect of capping GHG emissions on an already troubled economy; (2) the risk that such caps will encourage industry to relocate to other countries where emissions are not capped; and (3) the interests of states heavily dependent on coal power.

Nonetheless, it might be instructive for federal bill drafters (and perhaps the agency regulators who will draft the implementing rules) to study a handful of elements of the GHG cap-and-trade program that California's Air Resources Board (ARB) proposed last fall. There is a good reason to seek instruction. It is hard to imagine how the United States will live up to President Barack Obama's December pledge to achieve GHG emissions reductions at the percentages and on the time line he set out in Copenhagen without a federal cap-and-trade regime. Even if the ARB's proposal does not "resolve" this handful of issues, it might shed some more light on their intricacies.

California enacted its Global Warming Solutions Act¹—in which a cap-and-trade program is the centerpiece—in 2006. The Global Warming Solutions Act set 1990 emission levels as its baseline. Last fall,

the ARB proposed rules to implement the cap-and-trade program. The ARB expects to release its final draft proposed rules this summer and to finalize them at its October 2010 meeting. The ARB's proposed rules join the rules of the north-eastern states participating in the Regional Greenhouse Gas Initiative (RGGI)² as the most comprehensive domestic models for cap-and-trade programs.

Even with its own cap-and-trade rules, California will continue to participate in the Western Climate Initiative's (WCI's) regional cap-and-trade program in which a dozen western states participate.³ The ARB's proposed rules are generally consistent with the WCI's framework in terms of when they become effective, the emissions sources covered, the goals for emissions reductions, and the timetable for meeting those goals. California might impose rules more stringent than the WCI framework.

The handful of issues on which one might look to the ARB's proposal for instruction include: (1) the period during which emission sources' compliance obligation is measured; (2) the application of the cap-and-trade regime to fuel suppliers; (3) how emitters satisfy their compliance obligations through use of "offsets"; (4) the extent to which emission allowances or offsets can be banked; and (5) how the cost of compliance might be constrained.

Compliance Period. The ARB's proposed rule would measure emitters' compliance over a period of three years. In other words, emitters would have to hold sufficient allowances or offsets at the end of three years to accommodate their



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GHG emissions for the preceding three-year period. The bill passed in the U.S. House of Representatives, which requires annual reductions in allowance amounts, includes a borrowing scheme that permits the unlimited borrowing of allowances one year in advance, effectively creating a rolling two-year compliance period. The draft legislation introduced in the Senate by Sens. John Kerry (D-Mass.) and Barbara Boxer (D-Cal.) would use the same approach. Moreover, both bills would grant covered entities the right to borrow up to 15% of the allowances required to meet their compliance obligations from up to five years in the future. Borrowed allowances would be subject to an 8% interest payment. Although the ARB has yet to decide whether it will permit borrowing from future compliance periods, the relative simplicity of California's proposed three-year compliance period may be worth considering.

Fuel Suppliers. Initially, the ARB proposed including fuel suppliers in its GHG cap in the second compliance period: 2015-2018. The ARB is considering, however, moving up their obligation to the first compliance period: 2012-2015. Suppliers of all industrial, commercial, and residential fuel, including those that deliver natural gas and transportation fuel, e.g., gasoline, diesel, and ethanol,

would be subject to the cap based on the amount of emissions associated with the fuel supplied. Inclusion of aviation fuel in the California program is a topic of some controversy, as the airline industry points to a provision in the Clean Air Act (CAA)⁴ that preempts state regulation of aircraft emissions.⁵ Federal legislators, of course, will not face that preemption obstacle to keeping aviation fuel within a federal cap-and-trade program.

The ARB is not quite certain how to calculate the allowance or offset surrender obligation for fuels. It has asked for comments on four options: net carbon content; tailpipe combustion factor; life-cycle carbon intensity; and net carbon content plus some life-cycle emissions. If California is serving as a laboratory for democracy in this instance, there may be something to learn from how the ARB sorts out this matter of calculating allowances.

Of course, to some, the inclusion of fuel suppliers smacks of “double-counting.” In the first instance, the supplier is subject to the emissions cap and the resulting compliance obligations. Then, their customers who use the fuel to power their operations—electricity generators, cement, aluminum, glass, and iron and steel producers—are also subject to the cap and resulting compliance obligation. Proponents of federal cap-and-trade bills seem equally unconcerned with the charge of double-counting, as they embrace “upstream sources,” such as fuel producers, within their economywide cap-and-trade net.

Offsets. There are a couple of critical issues involved in using offsets in cap-and-trade programs. One is the extent to which an emitter can satisfy its compliance obligation by acquiring offset credits as opposed to emission allowances. Another is the manner by which the integrity of offset credits is assured.

On the former, the ARB’s proposal would allow covered emitters to satisfy no more than 4% of their compliance obligation using offsets. This is comparable to the RGGI approach, which starts by allowing emitters to satisfy 3.3% of their compliance obligations

with offsets and increases that through a variety of “safety valves” to as much as 5 or 10%.⁶ The House-passed bill and the draft legislation introduced in the Senate would allow covered sources to use offsets to fulfill as much as 30% of their compliance obligation.⁷ The much greater allowance for offsets in the federal legislation stems, no doubt, from the desire to win the votes of farm state members. Members from farm states expect offsets to create moneymaking opportunities for their constituents.

As far as assuring the integrity of offsets, the ARB proposed a series of “rigorous” eligibility criteria that appear similar to the RGGI’s criteria.⁸ “Additionality”—that a reduction, avoidance, or sequestration of GHG emission would not have occurred but for the offset project—is, of course, a key criterion. While the ARB expects to adopt methodologies that validate offsets, its initial proposed rule did not suggest any. The House bill similarly dodged specificity by calling for the creation of an Offsets Integrity Advisory Board.⁹ The ARB’s initial proposal promises only to state what geographic limits, e.g., in-state, out-of-state, international, might apply to eligible offsets. The RGGI expressly contemplates use of out-of-state offsets,¹⁰ and both the House-passed bill and the Senate’s draft legislation expressly sanction substantial use of offsets arising from international projects.¹¹

Banking. Like other regulatory bodies that have had to design cap-and-trade systems, the ARB has recognized the desirability of building some flexibility into the system. Among the few hints in the preliminary draft rules is that the ARB will likely let allowances and offsets be “banked” in holding accounts for use during future compliance periods. The House-passed bill would also allow banking and even borrowing: dipping into future years’ accounts to satisfy the present year’s compliance obligations.¹² Because of its three-year compliance period, which builds in some year-to-year flexibility, borrowing may not be so critical to the California regime. The ARB’s fall proposal leaves open the pos-

sibility, however, that the ARB will allow borrowing in its ultimate rule.

Cost Containment. Even with the use of offsets and banking (and potentially borrowing), there remain concerns that capping GHG emissions will overburden a lagging economy. Like other regulators and legislators that have gone before, the ARB appears willing to adopt cost-containment measures. The House-passed legislation, for example, includes a “strategic reserve” from which reserved or unsold allowances could be released to dampen emission allowance prices if their price became too great.¹³ The Senate’s Kerry-Boxer Bill contains a similar “Market Stability Reserve.”¹⁴ In its proposal, the ARB indicated its willingness to use such a reserve. It also held open the possibilities of relaxing the 4% limit on satisfying compliance obligations through use of offsets, expanding the acceptable types of offset projects beyond those otherwise allowed, and “price collars.”

If the Senate musters the will to start working again in earnest on a comprehensive, federal GHG cap-and-trade bill, despite the substantial political obstacles in its way, the bill’s drafters might learn a thing or two from the ARB’s efforts to develop its own program.

(Endnotes)

1. A.B. 32 (Cal. 2006).
2. See TOM MOUNTEER, CLIMATE CHANGE DESKBOOK §4.2 (Envl. L. Inst. 2009) [hereinafter DESKBOOK].
3. See *id.* §4.3.
4. 42 U.S.C. §§7401-7671q, ELR STAT. CAA §§101-618.
5. 42 U.S.C. §7573, ELR STAT. CAA §233. See also Letter from K. Welsh, Air Transport Association, to M. Nichols, Chair, ARB, re: Preliminary Draft Regulation for a California Cap-and-Trade Program (Jan. 11, 2010).
6. See DESKBOOK §4.2.4.1.
7. Tom Munteer, *Comprehensive Federal Legislation to Regulate Greenhouse Gas Emissions*, 39 ELR 11068, 11083 n.253 (Nov. 2009).
8. See DESKBOOK §4.1.3.2.
9. Munteer, *supra* note 7, at 11083 n.247.
10. See DESKBOOK §4.2.4.1.
11. Munteer, *supra* note 7, and accompanying text.
12. Munteer, *supra* note 7, nn.263-69 and accompanying text.
13. Munteer, *supra* note 7, nn.255-62 and accompanying text.
14. S. 1733, Clean Energy Jobs and American Power Act, §726 (2009).