



July 9, 2009



## Cap-and-Trade Bill Passed by U.S. House: A Summary

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**The U.S. House of Representatives passed a landmark global warming bill (HR 2454) by a vote of 219-212 on June 26, 2009. The American Clean Energy and Security Act of 2009 (ACES) seeks to, among other things, establish a nationwide cap-and-trade system for greenhouse gas (GHG) emissions. The bill now moves to the Senate where Majority Leader Reid has called for a September 18 deadline for all committee markup on the Senate version of the legislation.**

Title III of HR 2454 represents the centerpiece of the bill that must clear the Senate to implement the cap-and-trade system. The remaining sections of the nearly 1500 page bill are replete with numerous provisions that include a nationwide renewable energy portfolio standard, a green-jobs employment package, and numerous industry incentives. Critics of the bill contend that the political logrolling necessary to pass the controversial bill through the House has resulted in massive giveaways to numerous interest groups. Similar negotiations and horse trading in the Senate will likely result in two distinctly different bills coming out of Congress. Despite these differences, the overall push for a cap-and-trade system appears to have sufficient momentum to prevail as the preferred regulatory mechanism for GHG regulation. The following summarizes Title III of HR 2454, which section proposes to establish the cap-and-trade system.

### **Cap-and-Trade**

Title III of HR 2454 bill adds a Title VII to the already existing Clean Air Act (CAA), 42 U.S.C. § 7401 *et seq.* References to various provisions below therefore refer to sections labeled Sec. 701 *et seq.* as they would appear in the Clean Air Act. The new CAA Title VII would establish a cap-and-trade system for GHG emissions. The cap gradually reduces GHG emissions from designated sources to 83 percent of 2005 base levels by 2020, and 17 percent of 2005 base levels by 2050.

The bill defines the following as GHG emissions: Carbon Dioxide; Methane; Nitrous Oxide; Sulfur Hexafluoride; Hydrofluorocarbons (HFCs); Perfluorocarbons; Nitrogen Trifluoride; other designated manmade pollutants.

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(Sec. 711) Each GHG is given an equivalent measurement in terms of metric tons of CO2 emissions. For example, one metric ton of methane is equivalent to 25 metric tons of CO2. (Sec. 712)

The Environmental Protection Agency (EPA) will issue a limited number of emission credits beginning in 2012. Credits issued in a given year are referred to as “vintage year” credits. In other words, the first year of credits would be vintage year 2012 credits. The EPA will then allocate a certain amount of these credits to specific industries, and it will auction the remaining unallocated credits each quarter. The number of credits issued each year will increase until 2016 to allow for additional covered entities to come online under the regulation. The EPA will then decrease the number of available credits each year until 2050. (Sec. 721)

The bill prohibits covered entities from emitting in each calendar year an amount of GHGs greater than the number of credits they hold (including offset credits) as of April 1 of that year. (Sec. 722) Covered entities generally include electric utilities and stationary sources that generate over 25,000 metric tons of CO2 equivalent emissions annually. (Sec. 700) Failure to comply will result in a payment of twice the fair market value of the GHG emission credits trading that year. (Sec. 723) Anyone can trade in emissions credits, and the owner of a credit may request that the Administrator retire those credits. (Sec. 724)

The bill excludes emissions from certain sources, such as electric utilities, that result from combustion of the following sources: petroleum or coal based liquid fuels; natural gas liquid; renewable biomass; and petroleum coke or gas derived from petroleum coke. (Sec. 722(b)) This provision avoids double counting those emissions because the producers of those sources (i.e. refineries, etc.) already account for the emissions that would result from fuel combustion.

Covered entities can “bank” and/or “borrow” credits. Banking means that the entity can hold on to credits for use in future years. (Sec. 725) In other words, the entity can acquire 2015 vintage credits and either (1) use those credits to meet its 2015 emissions requirements, or (2) hold the credits for use in any subsequent year (i.e. it can use 2015 vintage credits to meet its 2017 emission requirements). Borrowing is the opposite effect. An entity can use credits from the immediately subsequent vintage year - interest free - to meet the current years’ requirements. (Sec 725(c)(2)) In other words, in 2015 the entity can apply credits from vintage year 2016. A covered entity may also engage in longer term borrowing (up to 15% of total allowances) for 1 to 5 years in the future, but this borrowing incurs an 8% annual carbon equivalent interest calculation.

The bill establishes a “strategic reserve” of credits. Once in each quarter, the Administrator will auction off these strategic reserve allowances to covered entities. Only covered entities are allowed to bid/purchase the strategic reserve credits at auction. (Sec. 726) The EPA will fill the strategic reserve by allocating 1% (2012-19), 2% (2020-29), and 3% (2030-50), respectively, of the emission allowances for each calendar year to the reserve. The bill provides various other limits on the price and size of the auctions.

For entities that already fall under the permitting requirements of Title V of the Clean Air Act, the allowance and credit requirements of this cap-and-trade system must be incorporated in those permits. (Sec. 727) In other words, the

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issuing authority for the Title V permit must require that the permitted entity demonstrate that it holds sufficient allowances or credits under the cap-and-trade system before the authority will grant the permit.

### **Allocations**

The allocation of emission allowances serves a critical role in the cap-and-trade system. As discussed above, each year the EPA will issue a limited number of emission credits. The amount of credits will increase slightly in the first few years as new entities come on line, and then the amount will decrease each year. Although these emissions credits are tradable, EPA's initial allocation of the credits each year is governed by the bill. Industries have lobbied heavily to receive allocation rights under the bill. The initial allocations are, in a sense, a free endowment for existing GHG emitters. This mechanism reduces the cost impact on existing emitters by allowing them to continue their current operations without purchasing all of the necessary credits at an auction. The entities may also choose to shut down or reduce their emitting operations and simply sell their allocations on the open market. Critics argue that the allocation provision, as opposed to a complete auction of the credits, results in a windfall for industries that are the cause of GHG emissions. Supporters contend that the provisions are necessary to allow the energy industry and other sectors to continue to operate once the cap-and-trade system is in operation.

The following table shows some of the major allocations of emission allowances:

Vintage yr. > Sector_v	2012-13	2014-15	<b>2016-25</b>	2026	2027	20
Electricity Consumers (utilities)	43.75%	38.89%	<b>35.00%</b>	28%	21%	14
Small LDCs	0.50%	0.50%	<b>0.50%</b>	0.40%	0.30%	0.2
Natural Gas Consumer	n/a	n/a	<b>9%</b>	7.20%	5.40%	3.6
Home Heating Oil and Propane	1.88%	1.67%	<b>1.50%</b>	1.20%	0.90%	0.6
Low Income (see Sec. 791)	15%	15%	<b>15%</b>	15%	15%	15
Investment in Efficiency and Renewable	9.50%	9.50%	<b>6.5%; 5.5%; 1.0%</b>	4.50%	4.50%	4.5

Several other specific provisions allocate emissions credits to various industries over the years. See Section 782 for a complete list.

The EPA will promulgate regulations that allow for the exchange of GHG emission credits from the California, RGGI or Western Climate Initiative emission allowance programs. (Sec. 790) This provision should allow the state and regional trading credits to retain value as they are incorporated into the national system. At the same time, the bill prohibits any State or other political subdivision from implementing a cap-and-trade program that covers any capped emissions emitted during the years 2012 through 2017. (Sec. 861)

The remaining credits that the bill does not allocate will be available for auction pursuant to the procedures set forth in Section 791 and further EPA regulations that will be forthcoming. The EPA will hold auctions four times per year. Any bidder in the auction must disclose the identity of the beneficial owner.

### **Offsets**

In addition to emission credit allowances issued by the EPA under Section 721 and allocated or auctioned as described above, HR 2454 allows covered entities to use “offset credits” to meet its GHG emission obligations. The bill establishes an Advisory Board within the EPA that will review projects and make recommendations to the EPA on whether the project should be eligible for offset credits. (Sec. 731) These projects would involve reductions or avoidances of GHG emissions that would not otherwise be covered by the cap-and-trade system. Based on these recommendations and coordination with other agencies, the EPA will promulgate regulations within two years that will govern the generation and issuance of offset credits. (Sec. 732) This section

does not govern offset credits from the agricultural and forestry industries. Title V of the bill governs those industries and authorizes the U.S. Department of Agriculture (USDA) to oversee that program.

Once generated and issued, offset credits can be traded or sold on the emission credit market. The EPA will determine what projects qualify for offset generation. The EPA (and USDA where applicable) will also establish procedures for verifying offset projects. (Sec. 736) Accredited third party vendors would likely fulfill the task of verifying offset projects. This will likely lead to job creation for third party verifiers of offset credits. Similarly, the EPA (or USDA) will also conduct or have conducted periodic audits of the offset program. An eligible program will be given a “crediting period” from 5 to 10 years (possibly longer for sequestration programs). During this period, the program can generate offset credits equal to the amount of carbon equivalent emissions that are reduced or avoided. The EPA, or a State or Tribal authority, will also conduct random audits of offset programs

Offset credits will only be approved and issued for projects that actually reduce or avoid emissions from after January 1, 2009. (Sec. 740) In other words, measures taken to reduce or avoid emissions that occurred prior to 2009 will not qualify for generation of offset credits. The bill provides for limited exceptions related to state or tribal GHG emissions trading programs that were in effect after January 1, 2001. Other trading programs may also qualify at the discretion of the EPA. Under certain circumstances, international offset credits may also be available in countries that have a bilateral or multilateral agreement with the United States. (Sec. 743)

### **Regulation of Agriculture and Forestry Related Offsets by U.S. Dept. of Agriculture (USDA)**

In the final version of the bill that passed the House, HR 2454 created a separate Advisory Board under the authority of the U.S. Dept. of Agriculture (“USDA”). Similar to the EPA Advisory Board created under Title III, (CAA Section 731), the “USDA Greenhouse Gas Emission Reduction and Sequestration Advisory Committee” will make recommendations to the USDA regarding domestic agricultural and forestry offset programs. Following those recommendations, the USDA will establish a list of eligible agricultural and forestry operations that are eligible for offset programs. The USDA will then issue offset credits to the project developers that will be available for trading on the open market. This provision could result in a financial windfall for agricultural and forestry operations that undertake carbon reduction, avoidance or sequestration practices.

Another provision in the bill amends the Clean Air Act to make it clear that indirect land uses outside of the United States will be excluded from regulatory requirements related to lifecycle GHG emissions. (Sec. 551) The issue here involves the method of calculating GHG emissions for the biofuels industry. The production of corn-based ethanol results in the diversion of corn as a food crop. As a result, the market for foodstuffs goes up, and foreign countries often increase slash and burn agriculture in order to plant more corn for food. There is an ongoing debate as to whether the emissions related to those land use changes should be calculated against the corn-based ethanol producers. Recent California regulations have included the so-called “indirect land use” effects in their calculations. HR 2454 amends the Clean Air Act such that the indirect

land uses from a foreign country do not count against producers of biofuels such as corn-based ethanol.

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