Potential Implications of President Obama's "Cap and Trade" Program

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President Obama has answered the questions of whether a carbon (greenhouse gas) regulatory scheme will be enacted and what form it will take. As opposed to a carbon tax, the president recently submitted a budget calling for a "cap and trade" regime, which he believes will produce revenue for the federal government in the range of $78.6 billion in 2012 and $645.7 billion from 2012 to 2019. Depending on how this program is implemented, its effects may be deep and broad. Cap and trade is modeled after a successful program to reduce acid rain emissions.

The "cap" aspect of the program is that the government makes available a limited number of carbon allowances—fewer each year than the prior year's carbon emissions. President Obama proposes reducing emissions 14 percent below 2005 levels by 2020. The "trade" aspect is a secondary market in which those capable of reducing emissions below their allowances can sell entitlements to those whose emissions will exceed their existing allowances. Currently, there are several carbon-trading markets. However, because no national cap exists, carbon has been trading at low levels. For example, in the market operated by the Regional Greenhouse Gas Initiative, covering power plant emissions in 10 Northeast states, the trading price for carbon is about $3.20/ton. As another example, the U.S. capital recently acquired 30,000 tons of carbon offsets on the (voluntary) Chicago Climate Exchange for $89,000, or $2.96 per ton.

Beyond the broad strokes, complex issues are involved. The first issue is the point at which emission allowances will be required. One school of thought favors requiring allowances at the point of discharge. This approach has the benefit of allowing the program to be targeted at specific emitters and of directly rewarding those that can reduce emissions. Some proposals would apply the carbon regulation solely to power plants, others to "major sources" as defined in the Clean Air Act (perhaps best described as sizeable industrial and commercial facilities in a host of industries). Most, however, would not require allowances for ancillary sources of emissions, such as private cars. All of the approaches suggested to date would only partially address total emissions of greenhouse gases. Because coal-fired power plants account for only 40 percent of U.S. carbon emissions, it may be argued that a program placing 100 percent of the emission-reduction burden on this one source category would be fundamentally unfair.

Another school of thought is to apply the allowance requirement to the seller of carbon-containing substances at the point at which they are tendered into interstate commerce,*i.e.*, a "first sale" approach. For each ton of coal, oil, natural gas or other greenhouse gas-containing substance produced or sold, the producer/seller would have to acquire allowances equal to the per-ton greenhouse gas emissions that would result from the combustion or other activity causing the release of greenhouse gas. A benefit of this approach is that it can be simple to administer and captures all emission sources. A concern with this plan is that it may be construed as a very broad tax across the entire economy.

The second issue is: How will allowances be provided? President Obama's budget anticipates that all allowances will be auctioned in the first instance. Based upon estimates of initial greenhouse gas reductions, the budget assumes a price of $20/ton for the first auction, which would occur in 2012. The problem with this approach is potential price shock and regional inequality. For customers of utilities that rely on coal-fired generation, a $20/ton auction fee will result in a 40-percent increase in the residential cost of electricity. Some industry observers anticipate that the auction price may be in the $50 to $70 per ton range, which may exacerbate the price shock to retail consumers. Most coal-fired generation is located in the Midwest and South, which is likely to result in a wealth transfer from these regions to the West Coast and Northeast. Strong congressional reaction is likely, and the divergences may be more regional than based upon party affiliation.

In the European Union ("EU"), which has had a cap and trade program for several years, 95 percent of the allowances were initially allocated at no cost to traditional emitters. Those entities that were able to reduce emissions could "trade," *i.e.*, sell, allowances to those who needed them. This allocation methodology significantly mitigates rate shock, but may lead to an initial overallocation, which is what occurred in the EU, severely undermining the secondary market envisioned for the original EU program. More potentially challenging for the United States is that an EU-like allocation methodology is unlikely to generate revenue for the federal treasury. The Obama budget depends heavily on expected revenues from allowance auctions to fund a number of programs.

The final issue is: What should be done with the revenue? The Obama budget contemplates that 20 percent of the auction revenue would be devoted to alternative energy development and 80 percent to tax credits for the working poor. However, other proposals envision that all of the revenues received by the federal government would be paid out to taxpayers in the form of dividends. If there is not some form of direct redistribution of carbon auction revenue to those who actually pay the higher costs for energy, the program may be considered a huge redistribution of the tax burden.

There are indications that several bills contemplating various forms of carbon regulation will be introduced within the next two weeks. The debates should be lively and the stakes large. It is important to note that the front runner for administering this complex program is the Federal Energy Regulatory Commission ("FERC"). If legislation is not passed this year, the U.S. Environmental Protection Agency ("EPA") may regulate greenhouse gas emissions under the Clean Air Act, a prospect whose complexity would make any form of cap and trade regulation look simple. We will provide updates on the extent that consensus develops concerning the issues discussed above.

For Further Information

If you have any questions about President Obama's cap and trade program or would like more information, please contact Stephen L. Teichler, Seth v.d.H. Cooley, any memberof the Energy, Environment and Resources Practice Group or the attorney in the firm with whom you are regularly in contact.