

Alert 10-154



Energy and Climate Change: A Race between Congress and the EPA

Summary

The oil spill in the Gulf of Mexico has increased the chances that Congress will send energy-related legislation to the President's desk before the midterm congressional elections in November. Senate Majority Leader Harry Reid (D-NV) has indicated that he will bring a measure to the Senate floor by July 26, 2010 that addresses energy and encompasses issues related to the oil spill (likely in the form of some sort of restriction on off shore drilling), renewables (likely in the form of a Renewable Energy Standard), and energy conservation. Will that legislation also include a price on carbon in the form of cap and trade for any sector? We note that last year the House of Representatives passed and sent to the Senate H.R. 2454, the *American Clean Energy and Security Act of 2009*, comprehensive climate change legislation which, in part, sets goals for reducing emissions of greenhouse gases ("GHGs"), including carbon dioxide, via an economy-wide (read: utility, industrial and transportation sector) cap-and-trade system. The Senate has now gotten involved, with Majority Leader Reid soliciting Senate committees proposals, especially those that can muster the support of a 60-vote super-majority by Reid's July 26th deadline to bring a bill to the Senate floor. Given the debate, and divisions, on climate change, it is not clear whether any cap-and-trade system (economy-wide or merely utility only) for greenhouse gas emissions will ultimately be included in an energy bill that reaches the President's desk. However, if Congress fails to act in this area, the Environmental Protection Agency ("EPA") will step in and use its authority under the Clean Air Act (42 U.S.C. 7401) to regulate greenhouse gases from the utility, transportation and industrial sectors, and there is a small possibility that such regulation by EPA will include a cap-and-trade program. EPA has already taken several steps to regulate GHGs.

The following article discusses the efforts to enact measures that regulate GHGs and where the fault lines lie in the ongoing debate.

Energy and Climate Change Measures in the 111th Congress

Waxman-Markey's Comprehensive Climate Change Legislation, including Cap-and-Trade

There have been a number of energy and climate change proposals in the House of Representatives and the Senate in the 111th Congress. The one that has gotten the most traction so far – indeed, it passed the House - is H.R. 2454, sponsored by Congressmen Henry Waxman (D-CA-30) and Edward Markey (D-MA-7) ("Waxman-Markey"). Waxman-Markey is a comprehensive bill that addresses not just the regulation of carbon emissions through cap and trade, but also renewable energy and energy efficiency.

With regard to cap and trade, Waxman-Markey sets goals for reducing emissions of GHGs, including carbon dioxide, from stationary sources, including industry and electric utilities, in several increments through 2050. By 2050, emissions would have to be reduced to 80 percent of 2005 levels for covered entities. The EPA would be required to equate these emission reduction goals or "caps," into an annual "tons of carbon" limit to achieve these reductions, beginning in 2012. Sources would be given an "emissions allowance," that is, a limit on tons of GHGs that the source can emit, and sources that emit less GHGs than allowed under the caps will have "credits" that they can then trade to others who exceed their emission allowance. Waxman-Markey would set a floor on the cost of allowances at \$10 per ton (in 2009 dollars) and allow it to increase by 5 percent annually with the expectation that it would reach \$28 per ton by 2025.

The legislation also contains an RES - or Renewable Energy Standard – that sets standards for the amount of energy that electric utilities must generate from renewable resources and electricity savings – 6 percent of a utilities energy "portfolio" must come from combined renewable resources and savings by 2012, and 20 percent by 2020. It also provides

large investments to the "green" economy, authorizing \$100 billion over 10 years for hybrid cars, biofuel development, increased alternative energy use, and smart grid power. In addition, Waxman-Markey requires the development of a comprehensive carbon capture and storage strategy.

Finally, it addresses energy efficiency and conservation and folds in the commercial and residential building sector by setting national energy efficiency requirements for residential and commercial building construction.

Waxman-Markey passed the House of Representatives more than a year ago, on June 26, 2009, and was sent to the Senate, but by the slimmest of margins – only six votes.

Kerry-Lieberman's Comprehensive Climate Legislation, including Cap-and-Trade

As noted above, Senator Reid has asked committee chairs to provide energy proposals to him before the July 26 deadline to bring a bill to the Senate floor. Of the proposals currently under discussion, only one has a mandatory cap-and-trade system comparable to Waxman-Markey. *The American Power Act*, proposed by Senators Kerry (D-MA) and Lieberman (I-CT) ("Kerry-Lieberman") back in May, 2010, outlines a comparable cap-and-trade program to Waxman-Markey. Both have almost identical emissions targets, hoping to cap greenhouse gas emissions by 17 percent below 2005 levels by 2020 and 80 percent below 2005 levels by 2050. For those who emit less pollution, there would be a market for the trading of emissions comparable to what is established under Waxman-Markey. Kerry-Lieberman, however, does put a "price collar" on emissions allowances, specifically referring to allowance prices that start at \$12 per ton and are capped at \$25 per ton (but increased annually for inflation). The goal is to keep the prices for allowances affordable and thus keep them within reach for domestic industries.

Kerry-Lieberman has a renewable component. It authorizes \$70 billion over 10 years for clean transportation, renewable energy, and advanced nuclear and coal technology, comparable to Waxman-Markey. Kerry-Lieberman, however, provides a number of incentives for the development of such technology; for example, it expedites the construction approval process for nuclear power facilities and gives beneficial grants and funding for plant operators. In terms of setting specific standards for renewable energy, the Waxman-Markey bill suggests 15 percent renewable electricity and 5 percent total energy efficiency by 2020, along with 75 percent new building efficiency by 2030, taking into account new lighting and appliance efficiency standards. Kerry-Lieberman, however, proposes the imposition of state-level standards, arguing that claiming to adhere to national standards will produce results that are weaker than anticipated.

Also different from the Waxman-Markey bill, the Kerry-Lieberman proposal includes provisions that allow for domestic offshore drilling, a provision that many believe is part of a larger effort to garner Republican support for the bill. By allowing states to reap 37.5 percent of the revenues from drilling off of their coast, the leadership behind the American Power Act hopes to substantively initiate a reduced dependence on foreign oil. In light of the Gulf oil spill, we can expect any such measures to encourage off-shore drilling to die a quick death on the Senate floor.

Kerry-Lieberman also creates transitioning programs that, if successful, will offset the projected cost of energy increase in the transition from an economy dependent on fossil fuels, to one incorporating alternative energy sources. This program, targeted toward the low-income individuals, would be funded by a portion of the auction revenues from cap-and-trade allowances. Finally, the Kerry-Lieberman proposal also seeks to curb the authority of the EPA in its ability to regulate greenhouse gases under the Clean Air Act.

Where Congress is Heading

There is no indication that the Kerry-Lieberman comprehensive, economy-wide cap-and-trade proposal enjoys the support of a majority of Senators. It is not a bi-partisan measure – the one Republican who initially supported the measure and worked with Senators Kerry and Lieberman, Senator Graham (R-SC), has withdrawn as a supporter of the bill. In addition, a number of Senate Democrats either sponsor or support other measures, which do not include cap-and-trade or include a modified cap and trade program to that proposed under Kerry Lieberman's bill. In fact, since the rollout of Kerry-Lieberman in May, Senators Kerry and Lieberman have reportedly been meeting with power company officials and environmentalists in an effort to secure consensus on a utility-only bill.

In drafting any compromise, Senators Kerry and Lieberman may well incorporate provisions from a number of competing measures. A recent proposal by Senator Bingaman (D-NM), the chair of the Senate Energy and Natural Resources Committee, which would cap GHGs from just the electricity sector may garner some Republican backing for a version of the Kerry-Lieberman bill, and it is reported that Senator Snowe (R-ME) is interested in it. A discussion draft by Senate Energy and Natural Resources Chairman Jeff Bingaman (D-N.M.) was released July 13, 2010. Under the draft, a cap and trade scheme would regulate emissions solely from the utility sector starting in 2012 and would cut emissions by 2020

by 17 percent from 2005 levels and 42 percent by 2030 - roughly the same cap as proposed under Kerry-Lieberman and Waxman Markey. The cap and trade system would apply to utilities that emit more than 25,000 metric tons of carbon dioxide-equivalent per year – roughly the same size sources as proposed under Kerry-Lieberman and Waxman-Markey. Dealing with the "what then to we do with the industrial sector?" conundrum that creeps in when contemplating a utility-only cap, the Bingaman draft allows large manufacturers to opt in to the cap and trade program

Some additional details of the cap and trade program proposed by Bingaman's draft:

1. The draft would provide 30 percent of total emission allowances by 2016 and would phase out allowances by 2022. Waxman-Markey provided 35 percent of emission allowances in 2016.
2. Like Kerry-Lieberman, the draft also includes a price collar to provide predictability of carbon allowance prices. The price of allowances would not be able to rise above \$25 a ton in 2012 and drop below \$10 per ton. The price ceiling would increase each year by multiplying 105 percent of the previous year's price ceiling and the inflation adjustment for that year. The price floor would be adjusted by multiplying 103 percent of the minimum auction price plus inflation of the previous year, according to the draft.
3. The draft bill would cap only the utility sector until after the president determines that the United States' five largest developing-country trading partners had taken comparable action to reduce their greenhouse gas emissions. Industrial sources would then be subject to the cap five years after the president makes such a determination. The president would conduct the first analysis by 2015 and would reassess the situation every two years.
4. The manufacturing sector would not receive free emissions allowances under the draft bill to offset potential increases in electricity costs. They could, however, opt in to the carbon pricing system. That provision is aimed at swaying moderate Democratic lawmakers, who have stressed the importance of allowing manufacturers the option to participate.
5. Bingaman's draft would preempt EPA from regulating industrial sources' GHG emissions until January 2018. It would also prohibit states from implementing or enforcing greenhouse gas regulations from regulated sources from 2012 through 2017

Less likely, Senators Kerry and Lieberman may incorporate provisions from, S. 2877, the *Carbon Limits and Energy for America's Renewal Act* ("CLEAR ACT"), sponsored by Senators Cantwell (D-WA) and Collins (R-ME). This act would put a "cap-and-refund" plan in place for carbon emissions – basically, a cap and trade scheme that covers the utility and industrial sectors but based on a governmental auctioning scheme for distribution of allowances. Carbon and other greenhouse gases would still be capped at increasing limits (20 percent by 2020, 83 percent by 2050). Under Cantwell-Collins, 75 percent of proceeds from governmental auction would go to consumers to offset energy cost increases, and 25 percent of proceeds would help to further reduce greenhouse gas emissions. This would, according to the bill's sponsors, remove any involvement by Wall Street in setting the price of allowances.

S. 1462, the American Clean Energy Leadership Act and "Energy Only" legislation

Some "energy-only" bills (that is, bills that have no provisions to regulate emission GHGs, whether through cap and trade or otherwise, but do nonetheless address renewable energy and energy efficiency) are gaining bi-partisan support in the Senate. For example, S. 1462, the *American Clean Energy Leadership Act*, another bill sponsored by Senator Bingaman focuses on increased overall energy production and efficiency in the United States, while also addressing issues of research and development, new technology, and energy market protection. This legislation, if successfully implemented, will quicken the pace at which clean energy technologies are developed and introduced to Americans, and will greatly increase energy efficiency in homes, government and corporate buildings, appliances, and equipment so that consumers don't bear the burden on costs that come from excess energy waste. The legislation also taps into more than 20 trillion cubic feet of natural gas resources, as part of an attempt to reduce domestic reliance of foreign energy sources. Finally, the bill encourages domestic investment in research and development with a four-year plan to double investment in energy innovation to \$6.6 billion. On June 17, 2009, the Senate Energy and Natural Resources Committee passed S.1462 by a bi-partisan vote of 15-8.

Building on S. 1492 bill, Senator Lugar's (R-IN) *Practical Energy and Climate Plan*, S. 3464, would cut emissions by more than 20 percent by 2030 by conservation and efficiency measures such as reducing the need for foreign oil by 40 percent by 2010, and cutting energy use by 11 percent by 2030. Senator Graham, who initially supported the Kerry-Lieberman legislation, has expressed his support for the Lugar bill.

In sum Senate is moving toward an energy measure that addresses some sort of restriction on off shore drilling, a Renewable Energy Standard, and energy conservation measures. If there is regulation of GHGs emissions under this bill, it will likely be in the form of a cap and trade scheme that only addresses (at least initially) the utility sector, giving the industrial sector a reprieve of regulating GHGs emissions until at least 2018 with likely preemption of EPA action in the utility and industrial sectors until then as well. Would the President sign such a bill? Likely yes.

EPA is moving ahead with Technological Controls

The Endangerment Finding

On December 7, 2009, in response to the decision of the Supreme Court in *Massachusetts v. EPA*, 549 U.S. 497 (2007) that GHGs were air contaminants, the EPA Administrator made two distinct findings regarding GHGs. The first finding, known as the Endangerment Finding, is applicable to stationary and mobile sources and concludes that GHGs threatened (endanger) the public health and welfare of current and future generations and these same GHGs, when emitted from new motor vehicle engines, cause or contribute to GHG pollution that threaten public health and welfare. See *Endangerment and Cause or Contribute Findings for Greenhouse Gases Under Section 202 of the Clean Air Act*, final Rule, 74 Fed. Reg. 66496 (December 15, 2009). The Endangerment Finding has the effect of triggering EPA action under the stationary source provisions of the Clean Air Act. The Endangerment Finding has come under attack both through petitions to reconsider and legal challenges. On June 18, 2010, District of Columbia Circuit Court of Appeals decision set aside one group of challenges to the Endangerment Finding until EPA considers pending petitions to reconsider the Endangerment Finding.

Mandatory GHG Emission Reporting Rule

Prior to the issuance of its Endangerment Finding, EPA, on September 22, 2007, and pursuant to the provisions of the FY 2008 Consolidated Appropriations Act/H.R. 2764, Public 110-161, adopted a Rule (40 C.F.R. Part 98) requiring the mandatory reporting of greenhouse gases from certain sources that emit 25,000 metric tons or more of GHGs per year. EPA's mandatory reporting regulations do not require sources to control their GHGs emissions, but it was not long after the initial rules were promulgated that EPA moved in that direction, further pressuring Congress to act.

EPA Acts to Control GHG Emissions from New or Modified Stationary Sources: The GHG 'Tailoring' Rule

On May 13, 2010, EPA issued a final rule setting thresholds for sources of GHGs that defined when permits will be required for new sources under the Prevention of Significant Deterioration ("PSD") provisions of the Clean Air Act. This rule applies only to relatively large commercial sources of GHGs. It is to be implemented in two steps.

The first step (January 2, 2011 through June 30, 2011) will require GHG sources subject to PSD permitting because of other types of emissions to also address GHG emissions. For these projects, GHG increases of 75,000 tpy per year will, inter alia, trigger the requirement that best available control technology (BACT) is to be used to control GHG emissions.

In the second step (July 1, 2011 to June 30, 2013), PSD permitting will cover new facilities that emit GHG emissions of at least 100,000 tpy, and modified facilities that increase emissions by at least 75,000 tpy, even if they do not exceed the permitting thresholds for any other pollutant.

Requirements for new sources that are built after June 30, 2013 have not been established by EPA, but it has said it would undertake another rulemaking in 2011 on a third step for phasing in GHG in which it will address whether certain smaller sources can be permanently excluded from permitting.

This rulemaking is known as the "tailoring rule" because it limits which facilities would otherwise be subject to PSD permitting. EPA promised to provide states with guidance related to BACT requirements for GHG sources.

In the absence of ambient air quality standards for GHGs, it is difficult to see how the Tailoring Rule will be justified under the PSD provisions of the Clean Air Act.

EPA Cap-and-Trade Programs

EPA has a number of successful cap-and-trade programs in place. The oldest and most successful is its Acid Rain allowance trading program designed to reduce sulfur dioxide emissions for the utility sector. It was established under Title IV of the Clean Air Act. It could be a model for a GHG trading program, particularly if it is limited to electric utilities and retains the simplicity of the Acid Rain program. There are major differences, however, between the comprehensive, economy-wide cap and trade programs proposed by Congress and the Acid Rain Program. Most notably, the Acid Rain program allows no offsets. Offsets, or emission reduction credits from non-covered sources in a cap and trade program, are a large part of many of the economy wide cap and trade programs proposed in Congress and are widely seen as a great tool for economic development and as a way to "bring in" non-covered sources under the cap. So far, however, EPA has eschewed cap and trade as a regulatory scheme to regulate GHG and decided to proceed with technological controls perhaps, in part, because it believes that will encourage industry to support the more flexible cap-and-trade

legislation – and, in part, due to EPA's recent woes in the Federal Circuit Courts of Appeal with getting approval of the CAIR rule and its progeny as discussed below.

EPA's Cap-and-Trade Programs Vacated

If the EPA does go ahead and regulates greenhouse gases by a cap-and-trade system, it must consider how to do so with a plan that will hold up on judicial review. Since 2005, it has seen Bush Administration cap-and-trade programs to reduce (1) mercury and (2) nitrogen oxide and sulfur dioxide emissions vacated by the D.C. Circuit Court of Appeals. The Clean Air Mercury Rule (CAMR) and the Clean Air Interstate Rule (CAIR) both would have utilized a cap-and-trade system. Both approaches were rejected by the D.C. Circuit Court of Appeals: (1) CAMR was vacated in 2007, *NRDC v. EPA*, 489 F.3d 1364 (D.C. Cir. 2007); and (2) CAIR was vacated in 2008, *North Carolina v. EPA*, 531 F.3d 896 (D.C. Cir. 2008). The U.S. Circuit Court of Appeals, however, reinstated CAIR – including the cap-and-trade system – until the EPA issued a new rule, 531 F.3d 896, 901 (D.C. Cir. 2008). On July 6, 2010, EPA released a draft of the proposed replacement rule, the Transport Rule. It contains limited cap and trade provisions. It is obvious that if EPA decides to adopt a cap-and-trade program without the benefit of legislation, it must do so very carefully. It is therefore likely that if EPA moves forward with regard to regulating GHGs from the utility and manufacturing sector, it will be under a "command and control" approach and technological (BACT) limitations.

Conclusion

The next few weeks will tell whether it is Congress, or the Obama Administration, that moves forward on regulating emission from GHGs sources. Congress is expected to wrap up major legislative action by early September, at the latest - and most say that if any action is to occur, it will occur before the August 9 recess. Following the August 9 recess, the fall campaign season begins for the midterm Congressional elections and it is likely that the Senate would lose focus on GHGs. It is important to note that a failure by Congress to come to a consensus on regulating GHG emission leaves the probability (some may say certainty) of GHG emission controls by EPA in the industrial and utility sectors starting in January 2011.

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