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June Proves To Be A Busy Month For ARB And Its Proposed Cap-and-Trade Program

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June was certainly an interesting month for those following the progression of California's Global Warming Solutions Act ("AB 32"), which requires that California cut greenhouse gas ("GHG") emissions to 1990 levels by 2020. The "linchpin" of AB 32 is a proposed cap-and-trade program, a market-based approach to reducing GHG emissions in which the California Air Resources Board ("ARB") sets a collective cap on GHG emissions and then allows under- and over-polluters to buy and sell credits among themselves. However, recent judicial and agency developments have altered the cap-and-trade landscape. At the very least, the cap-and-trade program, if it survives judicial review, will not begin in earnest until 2013 (instead of the planned January 1, 2012 start date).

LITIGATION DEVELOPMENTS

(1) Association of Irritated Residents v. California Air Resources Board

In 2009, a citizen's group, Association of Irritated Residents ("AIR"), challenged ARB's adoption of the cap-and-trade program found in the AB 32 Scoping Plan (the Plan for compliance with AB 32), alleging that ARB failed to adequately analyze alternatives to the cap-and-trade program, thereby violating the California Environmental Quality Act ("CEQA").

On March 18, 2011, Judge Ernest H. Goldsmith of the San Francisco County Superior Court agreed with AIR's contention that ARB was in violation of CEQA. Judge Goldsmith found ARB had not adequately weighed or analyzed the alternatives to the cap-and-trade program when it adopted an implementation strategy for AB 32. Judge Goldsmith's final order, including a writ issued on May 20, halted all rule-making activities related to the cap-and trade program until ARB complies with the requirements proscribed under CEQA. (For further discussion on this, please see prior article here.)

(2) District Court of Appeal Grants ARB's Petition for a Writ of Supersedeas

On June 1, ARB appealed Judge Goldsmith's final order to the First District Court of Appeal. ARB then filed a petition for a writ of supersedeas, which requested the Court confirm that Judge Goldsmith's injunction on the implementation of the cap-and-trade program was automatically stayed pending the determination of the underlying appeal. On June 3, the Court of Appeal issued a temporary stay while it considered whether the lower court's injunction was "mandatory" or "prohibitory." (For further discussion on this, please see prior article here.)

AIR argued that Judge Goldsmith's final order was *both* mandatory and prohibitory. The mandatory element, according to AIR, requires ARB to conduct an appropriate alternative analysis for the Scoping Plan. AIR argued that this part of the injunction may be automatically stayed pending the appeal. However, AIR argued the prohibitory element – the instruction in Judge Goldsmith's order preventing ARB from continuing to implement and develop its cap-and-trade program – is not automatically stayed once an appeal is filed.

ARB argued that the lower court's final order would force ARB to miss the first year deadline for completing the necessary rulemaking procedures as directed under the state's Administrative Procedures Act, thereby eliminating its ability to timely implement AB 32 in accordance with statutory requirements. This

injunction, according to ARB, results in improper interference. In the alterative, ARB argued, under a balancing of the harms test, the Court should grant a "discretionary" stay if an automatic stay is determined to be inappropriate.

On June 24, the First District Court of Appeal issued an order granting ARB's petition for a writ of supersedeas. Pending the Appellate Court's consideration of ARB's appeal, the San Francisco County Superior Court order requiring ARB to halt all development and implementation of the cap-and-trade program is stayed. This means ARB is permitted to continue to advance and finalize plans for the cap-and-trade program while the Appellate Court determines the merits of ARB's appeal.

Ass'n of Irritated Residents v. CARB, Case No. A132165, in the California First District Court of Appeal can be found here.

AGENCY DEVELOPMENTS

(1) ARB Releases Supplemental Analysis of Scoping Plan Alternatives

While the Court of Appeal took into consideration the arguments regarding ARB's petition for the stay, ARB pursued another course of action. On June 13, ARB released a revised and supplemental analysis of alternatives to the Scoping Plan (the "Supplement"). (The Supplement can be found here.) The release began a forty-five (45) day public review and comment period. In addition, ARB has scheduled two public hearings for July 8 and July 15 to discuss the Scoping Plan. ARB also formally noticed a hearing before the full Board for August 24, 2011.

The Supplement presents a revised analysis for five (5) proposed alternative measures to be potentially utilized in implementing AB 32's Scoping Plan and is much more detailed than the original environmental analysis. The Supplement reassesses the following alternatives, which were included in the original analysis:

a. A "no project" alternative (or taking no action at all);[1]

b. A plan relying on a cap-and-trade program for sectors included in a cap; [2]

c. A plan relying more on source-specific regulatory requirements with no cap-and-trade component;[3]

d. A plan relying on a carbon fee or tax;[4] and

e. A plan relying on a variety of proposed strategies and measures.[5]

This new analysis incorporates emissions projections that take into account current economic forecasts and already implemented reduction measures. All the alternatives discussed, excepting the no project alternative, would achieve 2020 target levels. According to the Supplement, ARB believes that the cap-and-trade program and the mixed strategy approach would have the best chance of success. Importantly, the Supplement not only includes a revised alternatives analysis, it also includes significant revisions to the amount of GHG emissions needed to reach 1990 levels by the target date.[6]

After the forty-five (45) day review period, ARB will consider and prepare written responses to the public comments received. This should discharge Judge Goldsmith's determination that ARB violated CEQA by commencing the implementation of the Scoping Plan prior to adequately responding to comments.

At the August 24 hearing, which will be at the Cal/EPA headquarters in Sacramento at 9:00 a.m., the Board will then determine, in light of the comments, responses and revised environmental analysis, whether the selection of the cap-and-trade program was appropriate. Thus, the Supplement offers a shield to protect ARB regardless of the determination of the appeal. With the Supplement and the subsequent review process, ARB retains the ability to request Judge Goldsmith dissolve his final order and injunction as the agency would have remedied the violations noted in the final order and would now be in compliance with CEQA.

(2) ARB Delays Required Compliance with Cap-and-Trade Program Until 2013

On June 29, ARB Chairwoman Mary Nichols told lawmakers at the California Senate Select Committee on the Environment, the Economy and Climate Change that ARB is planning to "initiate" the cap-and-trade program on January 1, 2012 but not "start the requirements for compliance" until January 1, 2013. Nichols stated the decision came "in light of the importance of this regulation to the success of California's climate change program and the need for all necessary elements to be in place and fully functional." (Nichols' full transcript can be read here.) In conjunction with news of this delay, ARB will release a draft of regulations regarding offset protocols and allowance distribution within the next two (2) weeks.

In her testimony, Nichols stated that the postponement of the compliance date would not affect the stringency of the program or the total amount of GHG emissions that industries would be mandated to reduce by 2020. Specifically, Nichols believes, "It gives [ARB] 2012 to work our stress tests, go through any issues anyone might raise…and come up with answers." In short, the delay will not extend the 2020 target date required by AB 32.

Under the delay, the quarterly auctions of emissions allowances that each large emitter in California must turn in would commence in the second half of 2012, and not in February 2012 as originally planned. Entities that emit more than 25,000 metric tons of carbon dioxide per year will begin trading credits at the end of 2012 to cover emission reduction obligations for 2013 and later.

The cap-and-trade program requires covered facilities to surrender allowances and offsets once every three (3) years. Under this newly announced delay, the original first three (3) year compliance period (2012-2014) will be shortened to two (2) years.

According to Nichols' testimony, the decision to delay the compliance requirements came after Nichols conferred with the State Attorney General's Office and experts on California's disastrous attempt to participate in deregulated electricity sales, which lead to widespread fraud and rolling black-outs experienced by much of the State in 2000-2001. Despite Nichols assertion that the pending litigation was not a deciding factor, many commentators believe that a principal reason for the delay is to ensure compliance with CEQA.

In an emailed statement issued by ARB clarifying Nichols' testimony, ARB spokesperson Stanley Young, stated: "ARB will be initiating all elements of the cap-and-trade program throughout 2012, including establishing a market infrastructure, developing market oversight mechanisms, conducting trainings, holding auctions and developing linkages with partners in the Western Climate Initiative. This will ensure that we have tested the program prior to moving into the first year of compliance. The only change is shifting the first compliance obligation to 2013."

Josh Margolis, CEO of CantorCO2e, a Cantor Fitzgerald LP subsidiary that provides financial services to the environmental and energy markets, offers the following take-aways from Nichols' statement, as determined through CantorCO2e's interactions with ARB staff:

a. The most significant change is excusing sources from the need to secure and retire allowances or offsets to account for 2012 emissions;

b. There will be no 2012 allowances issued;

c. There will be the same reduction obligation by 2014 as under the original schedule, but "[t]he reduction forced by the declining cap that was originally scheduled to occur over a three (3) year period will now occur over a two (2) year period;"

d. An underdetermined number of auctions will happen in 2012;

e. In the 2012 auctions, 2013 and future vintage allowances will be auctioned; and

f. ARB will issue a statement this week that clarifies and answers many of the above items, and addresses other issues as well.

Some commentators see this delay as a potentially detrimental roadblock for the future of the cap-and-trade program. Peter Asmus, a senior analyst at Pike Research, stated: "I think it's a sign of a lack of faith in the whole cap-and-trade concept, which was also shot down at the federal level…[It] shows the push back on the environmental regulations is even occurring in California."

However, not all are pessimistic. State Senator Fran Pavely (D), author of AB 32, had originally called this meeting to discuss the implications and consequences of *Ass'n of Irritated Residents v. CARB*. After the meeting, Pavely stated: "This modest delay in implementation is prudent. The one-year period will provide flexibility; allowing us to road-test market mechanisms to see how they will work, while ensuring that the greenhouse gas pollution reductions required by the program remain intact."

Margolis is equally optimistic about the delay, as he believes it might have the effect of keeping more businesses in the California. According to Margolis, "Chairman Nichols has delivered an elegant solution that will keep the environment whole and have a minimal impact on sources."

Again, only time will tell what the final determination of *Ass'n of Irritated Residents v. CARB* and the future of the cap-and-trade program as proposed by AB 32 will be. More updates to come...

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[1] This alternative is based on "existing conditions." In establishing this baseline, the Supplement reflects the current status of other Scoping Plan measures. This includes those already adopted by ARB under AB 32 or enacted independently by State Legislature. The Supplement estimates the no-project approach would fall 22 million metric tons of CO_2-equivalent emissions short of the 2020 target reduction levels.

[2] This alternative looks at several examples of cap-and-trade programs enacted throughout the country and internationally. The Supplement identifies problems associated with these existing programs and offers ways California can avoid similar concerns. The Supplement also proposes an "adaptive management program" that would require ARB to monitor local air quality impacts and provide adjustments in order to deal with such impacts. This provision is probably included in response to AIR's original challenge that the use of cap-and-trade could result in the concentration of emissions in low-income and minority neighborhoods.

[3] This alternative uses remediation measures that target specific sources of GHG emissions – including, but not limited to, oil and gas extraction plants, refineries, transportation sources, and cement plants. ARB states there is significant concern in implementing this alternative as it poses a substantial risk of emissions "leakage" or the relocation of these sources to other states.

[4] This alternative discusses examples of currently enacted fee programs and design considerations. ARB believes enacting a carbon fee or tax would be inefficient and potentially impossible. (In California, any tax must obtain a two-thirds (2/3) vote of the State Legislature and that any fee must be placed within the boundaries of California Supreme Court's *Sinclair* decision and Proposition 26.) ARB has leakage concerns in regards to this alternative as well.

[5] This alternative proposes a mix of the three previous alternatives, not including the no project alternative.

[6] The original Scoping Plan estimated that the 2020 target level was 427 million metric tons of CO_2-equivalent emissions (the 1990 level). Under a "business-as-usual" approach, which was assumed to result in 596 million metric tons of CO_2-equivalent emissions, the Scoping Plan estimated a reduction of 169 million metric tons. However, with the economic recession and the reduction measures currently implemented, the Supplement states the current reduction needed to attain 2020 target level is now 80 million metric tons. The 2020 level under the same "business-as-usual" approach is estimated to be 507 million metric tons.