Client Alert.

October 21, 2011

California Adopts Historic Cap-and-Trade Program for Greenhouse Gas Emissions

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Last night, California made history by enacting the nation's first statewide, comprehensive cap-and-trade program aimed at reducing greenhouse gas emissions. As the cornerstone of California's ambitious effort to implement Assembly Bill 32 ("AB 32")—the Global Warming Solutions Act of 2006—the cap-and-trade program was unanimously approved by the California Air Resources Board ("CARB") on October 20, 2011.

KEY PROGRAM FEATURES

AB 32 requires the state to reduce overall emissions to 1990 levels by 2020. The cap-and-trade program, intended as a flexible, market-based mechanism to reduce greenhouse gas emissions, is a controversial method to achieve this goal. The program sets a fixed limit on greenhouse gas ("GHG") emissions from major sources (the "cap") and reduces those emissions by gradually lowering the aggregate cap each year. Regulated businesses are issued allowances at the start of the program, and may purchase and sell those allowances, as well as offset credits, at auction or in private transactions (the "trade").

A declining cap on aggregate emissions by covered industries will start in 2013. The cap will initially be set at approximately 2% below the 2012 level of emissions. A specified number of "allowances" will be issued, representing approximately 90% of average emissions, with each representing one metric ton of carbon dioxide or its equivalent in other GHGs (commonly referred to as "$MTCO_2e$"). At the end of each compliance period, emitters must surrender allowances and/or "offset credits" (which may satisfy up to 8% of an entity's compliance obligation) in an amount equal to their GHG emissions during that period. (See our detailed description of allowances and offsets here). The state would then permanently retire the surrendered allowances, and issue a new, reduced set of allowances for the following compliance period.

The first phase of "covered entities" will be the electricity generation sector and large industrial sources with GHG emissions at or above 25,000 $MTCO_2e$ annually. The industrial sources are manufacturers of cement, glass, iron, steel, lime, and paper; petroleum refiners; producers of hydrogen and nitric acid; and suppliers of natural gas and other fuels. In 2015, the second phase of the program will expand to include providers of transportation fuels and residential and commercial fuels. Additionally, entities that do not meet the compliance threshold will be able to opt in as covered entities, or participate voluntarily in the trading market by holding allowances.

The proposed regulations require covered businesses to register and create an account with CARB or a designated account administrator. A tracking system will be established to track allowances and offsets as well as submittals and transactions. Businesses that do not surrender the appropriate number of allowances or offsets will be subject to CARB enforcement and penalties. Once a violation has occurred, a separate violation will accrue every 45 days that a covered entity remains out of compliance.

CHANGES FROM ORIGINAL PROPOSAL

CARB originally voted to adopt the cap-and-trade regulations in December 2010 (see our prior update here), but directed its staff to make a number of modifications to the regulatory language before making a final determination. The agency then issued two rounds of proposed revisions for public comment, in July and September of this year.

In response to public comments, CARB made extensive changes to the regulatory language. Although the overall structure of the program remained the same, the agency made numerous technical and administrative revisions. Perhaps the most significant change from the original proposal is the start date for compliance obligations, which has been postponed from 2012 to 2013. Other highlights include:

- Aligning with rulemaking efforts through the Western Climate Initiative to allow for linkage to a future multistate cap-and-trade program.
- Adding formulas to calculate compliance obligations for electricity providers.
- Clarifying that not all emissions requiring reporting under the related Mandatory Reporting Rule have compliance obligations (for example, biogenic emissions generated by biomass fuel sources).
- Providing that allowances unsold at auction remain eligible for re-auction at later dates.
- Providing that certain allowances issued in previous years may be used for compliance.
- Increasing quality control in the official tracking system.
- Allowing offset projects below certain thresholds to avoid the cost of annual verifications.
- Creating a process to determine if emission reductions associated with offset credits have been overstated and to invalidate a portion of credits as necessary.
- Providing for tracking and verification of offsets generated through “early action” offset projects.
- Providing that penalties for violations are to be calculated every 45-day period rather than every day.

POTENTIAL LEGAL CHALLENGES

Earlier this year, a state court ruled that CARB (1) failed to adequately describe and analyze alternatives in its Scoping Plan, specifically with regard to the cap-and-trade program; and (2) improperly began implementing the Scoping Plan prior to completing its environmental review process. (See here for our earlier summary of the ruling in *Association of Irritated Residents vs. CARB*).

On August 24, CARB approved a supplement to its environmental analysis (known as a Functional Equivalent Document or “FED”) with an expanded alternatives analysis to respond to the lawsuit’s assertions. Additionally, as part of its rulemaking on cap-and-trade, CARB adopted a program-specific FED as well as an Adaptive Management Plan that addresses localized air quality impacts. This establishes a framework for CARB to determine whether unanticipated environmental impacts have occurred relating to implementation of cap-and-trade, and to respond accordingly. However, the litigation is still ongoing, with plaintiffs asserting that they may pursue additional claims relating to the cap-and-trade program.

In addition, independent petroleum refiners and trade associations supported the unsuccessful effort in 2010 to pass Proposition 23 to delay the implementation of the portions of AB 32, including the cap-and-trade program. Further litigation to challenge the program is possible.

NEXT STEPS

At its meeting approving cap-and-trade, several CARB board members acknowledged the agency is stepping into uncharted territory, with the potential for unintended economic or environmental consequences. In recognition of this fact, CARB directed staff to closely monitor the effects of the regulations and report back frequently. CARB faces a deadline of October 28, 2011 to submit final regulations to the State's Office of Administrative Law (one year following the publication of the original draft regulations).

Covered businesses should now develop strategies for obtaining allowances and/or offsets, and/or reducing their emissions. Even businesses and private individuals that are not subject to the new regulations may be indirectly affected by increases in the cost of fossil-fuel energy as companies pass the cost of compliance to consumers, and those businesses should prepare for these impacts. Despite a general cooling of concern over climate change that seems to be resulting from the current economic challenges our country faces, California continues to charge ahead with implementation of AB 32, and companies that do business in California must plan accordingly.

Morrison & Foerster lawyers have closely followed the development and adoption of AB 32 and its implementing regulations. Its lawyers represent energy companies, clean technology industries, counties and cities, and manufacturing and transportation sectors that will be affected by the greenhouse gas regulations.

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