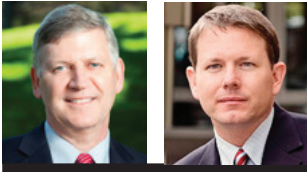


## Cap-and-trade war coming our way

*GHG regulations take effect in just over a year,  
but lots of work remains to be done if they are to succeed*



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**O**n Oct. 20, the California Air Resources Board approved controversial new “cap and trade” regulations on greenhouse gas emissions from electric utilities and large industrial sources after more than five years of debate. The new regulations — the most comprehensive climate change limits in the country — are likely to generate a political, legislative and judicial firestorm. They are being enacted at a time when many other states and Congress have turned away from GHG regulations, citing the burden they place on a struggling economy. CARB, however, had little choice but to act, in light of impending deadlines established by AB32 — California’s 2006 climate change legislation. AB32 requires California to reduce its GHG emissions to 1990 levels by 2020. The new CARB rules take effect Jan. 1, 2013, although CARB has already determined that major issues need to be revisited before the rules are implemented.

Cap and trade is a market-based framework under which aggregate emissions are capped and regulated businesses must obtain (through government allocations, auctions, or secondary trades) an allowance for each ton of GHGs they emit. In theory, the cost of allowances

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incentivizes businesses to adopt more efficient methods of production or find alternative technologies for resource use.

Cap-and-trade regulations have been successfully implemented before, but only in limited programs that regulate either one pollutant or one economic sector. EPA has implemented a cap-and-trade program for sulfur dioxide. Several Northeastern states have adopted cap-and-trade regulations limiting carbon dioxide emissions from power plants (that system is known as the Regional Greenhouse Gas Initiative or RGGI). Each famously achieved its objectives before statutory deadlines.

**Perhaps the most difficult problem California faces in enacting emissions limitations alone, without a federal program, is that at least some industrial users may leave the state to avoid the cost of compliance. The migration of GHG emissions sources from one state to another is known as ‘leakage,’ and CARB’s rules are not well-designed to prevent this.**

California’s program reaches much further than any market-based emissions program ever tried before. It attempts to regulate all economic sectors in California, and applies not just to carbon dioxide emissions, but to emissions of methane and other heat-trapping gases from most economic sectors. California’s approach creates enormous complexity, as CARB must attempt to equalize economic impacts upon diverse economic sectors. The program pits investor-owned utilities (IOUs) against

industrial sources, as they both must bid for the same limited emission allowances. While IOUs can pass the costs through to ratepayers, industries compete in international markets where cost pass-through is by no means assured. IOUs are therefore almost destined by the new rules to win the bidding for these allowances at the expense of California industry.

Perhaps the most difficult problem California faces in enacting emissions limitations alone, without a federal program, is that at least some industrial users may leave the state to avoid the cost of compliance. The migration of GHG emissions sources from one state to another is known as “leakage,” and CARB’s rules are not well-designed to prevent this. The fee on out-of-state generation is inequitably assigned. Publicly owned utilities will receive free allocations of allowances for their imported electricity, while other importers will have to bid for the allowances assigned to imported electricity. Furthermore, many utilities import electricity under contracts or agreements under which they will not be able to pass through allowance costs to consumers.

The anti-leakage approach for industries under the program is even more difficult to administer and understand. CARB will initially allocate emission allowances for free to industries subject to the program. But the number of allowances distributed will be based on CARB’s view of what the level of those industries’ emissions should be, not what they actually are. So, sometime between now and Jan. 1, 2013, in order to keep operating at historical levels, the affected industries may need to modify their operations to match governmentally mandated “benchmarks” for GHG emissions per unit of output. Some industries, most notably petroleum refining, will receive fewer allowances than they need to operate — even at recent recessionary levels.

There are likely to be many other provisions of the CARB rules that will come under attack. Here are some examples:

- **Cap:** CARB established the cap at emissions levels that are consistent with recessionary emissions rates, and are a few percent below emissions in California in 2008. CARB's cap will enforce limits that do not permit California's economy to recover to pre-recession levels.
- **Phase-in:** Other successful cap-and-trade programs established their caps up to five years in advance of enforcing them, so regulated entities had sufficient time to make investments in alternative compliance strategies. But CARB's program begins in a year, so business must either close, move or reduce operations rather than achieve compliance through investment.
- **Resource shuffling:** The regulations include a requirement that a responsible individual certify, subject to criminal penalties, that the regulated entity has not engaged in "resource shuffling." The CARB staff have explained that resource shuffling occurs when a regulated person switches from a high-GHG-emitting source to a low-emitting source (like from coal-fired power to wind energy), but is not effective in shutting down the source from which it is switching. To make the resource shuffling certification, an electricity purchaser that switches from a high- to a low-emitting electricity source must ensure that the former source does not find new customers or continue emitting at prior rates.
- **Allowances auctions:** The theory of auctioning allowances is that an auction "recovers the value of emissions rights" for the benefit of the public. This concept overlooks the fact that if the price signal works, then an auction requires regulated entities to pay twice — once when they buy allowances to keep operating, and again by investing in operational alternatives for reducing their GHG emissions.
- **Rebate of auction proceeds:** The auction of allowances to IOUs and cer-

tain other types of facilities will raise revenues that CARB has determined should be rebated exclusively to investor-owned utility ratepayers. The plan raises two fundamental questions. First, why does it serve the interests of the program to impose a fee on electricity users to pay for GHG allowances, and then rebate the fee back to the same people who paid the allowances' costs in the first place? Second, how are the goals of the program advanced by rebating to utility customers GHG allowance proceeds paid by nonutility customers? The rebate program does not appear to serve a purpose related to reducing GHG emissions, and calls into question the need for the auction.

- **Coordination with other programs:** CARB's cap-and-trade program shares the same goals as other programs established in California, notably the Renewable Portfolio Standard, under which certain utilities are required to obtain 30 percent of their electricity from renewable sources by 2020. Under the final version of the regulations, the renewable energy credits, or RECs, associated with renewable energy would be surrendered as part of the cap-and-trade program. RECs so surrendered would effectively be used to reduce the compliance obligation of the regulated party, acting as a sort of offset. This treatment of RECs undermines the cap of the cap-and-trade program, while simultaneously roiling the REC markets on which the Renewable Portfolio Standard depends.

After five years of rule making, at its final hearing on the regulations, CARB members expressed confusion about two fundamental concepts. One is the disruption of existing energy contracts. CARB stated that it had not taken any action to address sales of electricity by independent electricity generators under pre-AB32 contracts. Some of those contracts do not allow generators to pass through to the utilities the costs of GHG allowances. The result is that independent generators must purchase allowances from their

electricity utility customers, and then cannot recover the cost of such purchases in the electricity sold to the utilities. CARB has indicated that it hopes this issue can be worked out voluntarily between the parties to those agreements.

A similar result affects large public power agencies that import electricity for their public entity members. Through a last-minute definitional change, CARB shifted the responsibility for compliance from the individual members of some public power agencies to the agencies themselves. The result may require restructuring the agreements and regulatory programs under which public power agencies recover their costs. CARB decided in its final resolution approving the program to review this apparently unintended result.

CARB identified a host of other major issues that it agreed (in its approving resolution) required revisions to the just-approved regulations. One example is the possibility of offsetting the compliance obligations of the University of California by its investment in research or alternative energy facilities. Another example was an agreement to study whether there is an inequitable transfer of funds from certain state water authorities, which will pay significant GHG costs, to utility ratepayers under the rebate program. CARB also agreed that its resolution of issues relating to waste-derived fuels may need additional work.

All of this adds up to a cap-and-trade program that is very much a "work in progress" subject to ongoing modifications and considerable additional thought and discussion. Cap and trade does not work well under such circumstances. Regulated entities need to know what the future holds in order to react rationally. Rapid changes in direction simply mean that any investment in California is at risk.

Because the rules are still unsettled — and some would say, flawed — there are likely to be political, legislative and judicial attacks in the coming months. Given the stakes, it will be important for affected industrial and power generating entities to keep a close eye on these developments.