

California Issues Preliminary Draft Regulation for a Greenhouse Gas Cap-And-Trade Program

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California's Air Resources Board (ARB) recently issued preliminary draft regulations¹ to implement California's greenhouse gas (GHG) cap-and-trade program pursuant to the State's Global Warming Solutions Act of 2006. While the proposed regulations signal how ARB anticipates implementing much of the program, many key issues are yet to be resolved. Comments on the preliminary draft regulations are due by January 11, 2010. ARB will make the final proposed draft regulations available for review in Summer 2010 and expects to consider the final draft regulations at its October 2010 meeting. An initial auction of allowances is expected to occur in Fall 2011, with the overall cap-and-trade program going into effect on January 1, 2012.

In a Nutshell

California's cap on GHGs would cover about 85 percent of the state's combined emissions of GHGs. Under the draft regulations, the following sources would be subject to the cap: (1) electricity generators (including importers of electricity into California); (2) large industrial sources that emit at least 25,000 metric tons of carbon dioxide equivalent (MTCO₂e) annually; and (3) fuel suppliers for both stationary and transportation uses, including producers and importers of California reformulated gasoline, diesel fuel, and biomass fuel. These sources would have to either surrender allowances or obtain offsets to satisfy their obligations under the cap.

The draft regulations anticipate two initial compliance dates, with electricity generators/importers and industrial sources subject to the cap beginning in 2012 and fuel suppliers joining them in 2015. ARB is considering moving up the compliance date for fuel suppliers, however, which would subject all source categories to the cap by 2012. The draft regulations, as proposed, generally complement related state, regional, and federal regulations. Yet, ARB has identified several areas within the program that are still open to discussion and revision during the public comment process. As a result, early commenters on the preliminary draft regulations can have a meaningful impact on the final program.

Preliminary Compliance Timeframe and Covered Sources

The draft regulations propose three-year compliance periods with the first commencing on January 1, 2012. At the end of each three-year period, covered sources would be required to turn in enough "compliance instruments" to match their emissions during that period.

California would permit two kinds of compliance instruments to allow covered entities to meet their obligations under the cap: emissions allowances and offsets. Each allowance or offset would equal one MTCO₂e.

First Compliance Period: 2012-2015

Beginning in 2012, electricity generators that emit at least 25,000 MTCO₂e, including operators of stationary combustion and cogeneration sources, would fall under the cap. In addition, out-of-state generators that deliver electricity to the California Electricity Transmission and Distribution System would be subject to the cap.

Moreover, large industrial sources also would be subject to the cap beginning in 2012 if they produce at least 25,000 MTCO₂e annually and engage in stationary combustion, cement manufacturing, cogeneration, petroleum refining, hydrogen production, aluminum production, electricity generation, glass production, iron and steel production, lime production, natural gas transmission and distribution, nitric acid production, oil extraction field operations, gas extraction field operations, the production of industrial gases, pulp and paper production, and soda ash production. ARB estimates that the cap will cover 600 of California's largest emitters during this first period of implementation.

Second Compliance Period: 2015-2018

Assuming ARB adheres to its current proposal, fuel suppliers would be brought under the emissions cap beginning January 1, 2015. Suppliers of all industrial, commercial, and residential fuel would be subject to the cap based on the amount of emissions associated with the fuel supplied. In particular, entities that deliver natural gas would be affected, as would suppliers of fuels used for transportation, including gasoline, diesel, and ethanol. ARB is considering four options for calculating surrender obligations for fuels, including net carbon content, tailpipe combustion factor, life cycle carbon intensity, and net carbon content plus some lifecycle emissions.

Key Issues to be Resolved

- Because ARB is concerned about potential defaults by covered entities, the agency is considering whether to require surrender of compliance instruments at periodic intervals within the three-year period or simply shortening the compliance period to one year.
- As noted above, ARB is also deciding whether inclusion of fuel deliverers should be accelerated to 2012. Accordingly, businesses that use a significant amount of fuel (e.g., companies with large fleets) may wish to comment at this stage in ARB's deliberations, as fuel costs would be impacted sooner if fuel suppliers are subject to the 2012 compliance date.
- ARB is still evaluating how to calculate the surrender obligation for fuels and is asking for comments on the relative importance of fuel switching incentives, accounting consistency issues, scalability, and reporting complexity.

Allowances

ARB would create emission allowances in a number equal to the aggregate cap for emissions from all covered sectors. Although the Global Warming Solutions Act of 2006 states that the cap is designed to reduce California's 2020 emissions to its 1990 levels, ARB must determine the maximum allowable level of emissions under the cap. ARB has indicated that it would establish the initial baseline cap

based upon 2012 emissions. The cap would decline each year beginning in 2013, and fewer allowances would be issued on an annual basis. ARB has yet to decide how it will distribute the allowances but is considering distribution (1) through auction, (2) by freely providing them to covered sources, or (3) through a combination of both methods. An allowance-holder could use each allowance in any of several ways: (1) surrender it to comply with its obligation under the regulation, (2) bank it for future use, (3) trade it to another entity, or (4) ask ARB to retire it.

Key Issues to be Resolved

- The state expects to auction at least some minimum number of allowances at the start of the cap-and-trade program, with an initial auction of allowances in Fall 2011. As for how the proceeds of these allowances will be put to use, ARB has left the issue open. ARB also has not settled on the baseline cap or the annual reduction for each following year, but ARB is considering using an administrative adjustment process to avoid an overabundance (or lack of) available allowances.
- ARB has indicated that it will employ allowance cost containment measures but has not made a final decision regarding what the measures will be. ARB is considering the following options that would adjust the availability of compliance instruments in the market once upper price triggers are reached: (1) the use of a reserve account to release additional allowances when prices are high, (2) relaxing the quantitative limit on offsets, (3) the expansion of acceptable types of offset credits beyond the types that ARB would otherwise permit, (4) the "borrowing" of allowances from future compliance periods, and (5) price collars.
- Likewise, ARB is considering methods for ensuring that allowances do not fall below a specified price, including by (1) holding unsold allowances in a reserve account, and (2) using an auction reserve price (*i.e.*, setting minimum price).

Offsets

Besides allowances, covered sources could meet part of their compliance obligations through the purchase and use of emission offset credits. Offset credits would permit sources in capped sectors to exceed the amount of allowances issued but only to a point. Each covered entity could use offsets for up to 4 percent of the total amount of allowances that it would be required to turn in at the end of a compliance period. ARB would issue or approve credits for these offsets, which could be used by covered sources in lieu of purchasing allowances or reducing their own emissions. The preliminary draft regulations would require eligible offsets to meet "rigorous criteria" to demonstrate that they are (1) real, (2) additional, (3) quantifiable, (4) permanent, (5) verifiable, and (6) enforceable. "Additionality" is particularly important, as projects and actions would not be credited as offsets unless they were *in addition to* any reduction, avoidance, or sequestration of GHGs that a law or regulation would otherwise have required to occur.

Key Issues to be Resolved

- ARB is proposing to adopt methodologies that will quantify ARB-issued offsets, though ARB has yet to suggest any specific methodologies that it would adopt.
- ARB anticipates setting a start date after which projects would be eligible to produce offset credits (current proposal is January 1, 2007), as well as specifying whatever geographic limits (*e.g.*, in-state, out-of-state, international) apply to offsets.

- ARB has yet to spell out the process for verifying the GHG emission reductions, avoidances, or sequestration accomplished by offset projects and the manner in which verifying bodies can become accredited by the state.
- ARB is proposing to make offset purchasers responsible for replacement of offsets that are later determined to be ineligible, even though ARB will be issuing, verifying, and registering the offsets. The regulated community may resist this “buyer beware” approach.

Trading and Banking

ARB acknowledges the value of a flexible allowance trading regime, which would ensure that California’s cap-and-trade program is cost-effective. The preliminary draft regulations, however, contain only limited details about ARB’s allowance- and offset-tracking system, which ARB will begin developing in Spring 2010 and likely launch in Summer 2011. ARB is also proposing to link its cap-and-trade program to other trading systems (*e.g.*, WCI, RGGI, etc.) through agreements covering the details of those systems’ operations, such as how compliance is verified.

What’s more, ARB proposes letting allowances and offsets be “banked” in holding accounts for use during future compliance periods. Banked allowances would become increasingly valuable as the number of available allowances decreases under a declining emissions cap. Likewise, the increased expense of obtaining additional allowances at a later time creates an incentive for covered sources to reduce their emissions earlier in the process.

Key Issues to be Resolved

- ARB is considering whether to promote the trading of its emissions allowances on selected, existing carbon exchanges. The exchanges would be required to report all transactions to ARB, allowing ARB to monitor market prices and ownership. ARB could review these transactions for compliance with its regulations and approve transfers between parties.
- ARB is considering whether to establish a clearing facility for offset trades. Because ARB recommends that covered entities that submit ineligible offsets should be responsible for replacing them, ARB envisions the use of “make whole” contracts between offset purchasers and developers. ARB recommends that these offset contracts be cleared through a commercial clearing mechanism to maintain contract documentation until standardized contracts are developed suitable for exchange trading.

Enforcement

ARB will develop an enforcement system that monitors the market (*e.g.*, by identifying suspect transactions), and ARB expects to develop enforcement provisions that will correspond to each requirement for offsets in state regulations (*i.e.*, not holding sufficient allowances or offsets for a covered source’s emissions), as well as in any federal regulations that are eventually promulgated. These enforcement provisions include methods for calculating the number of violations and consequences for noncompliance. Penalties would be tied to California’s existing penalties for air violations.

Key Issues to be Resolved

- ARB's preferred approach to enforcement against ineligible offsets would be to require the covered entity using the flawed offsets to instead meet its surrender obligations by "making the system whole" and replacing the lost reductions of CO₂e by purchasing new offsets.
- ARB has yet to determine the combination of penalty levels and number of violations that it would use, but its stated objective is to eliminate any economic benefits of noncompliance.

Voluntary Renewable Electricity Generation

In an effort to maintain current incentives for voluntary investment in renewable power, ARB is proposing to withhold allowances from the budgets of sources that expect to have voluntary renewable power generation. Under the proposal, the amount of voluntary renewable power expected to be generated in a given compliance period would be calculated and that amount would be withheld from the budget. The actual renewable power generation that occurred would then be measured, and the held allowances would be retired based upon demonstrated emission reductions.

Cap-And-Trade Related Revisions to ARB's Mandatory Reporting Regulations for GHGs

The preliminary draft regulations include a preview of proposed revisions to its Mandatory Reporting regulations that will be released in early 2010, including the following:

- ARB may propose key modifications to the reporting threshold, including switching reporting to CO₂e rather than CO₂-only emissions and lowering the reporting threshold from 25,000 MTCO₂e to 10,000 MTCO₂e.
- ARB will propose a new requirement of annual verification of emissions data reports for all facilities above the 25,000 MTCO₂e threshold.

Interplay with Regional and Federal Programs

Western Climate Initiative

California will continue to participate in the Western Climate Initiative's (WCI's) cap-and-trade program. As currently proposed in the preliminary draft regulations, the three-year compliance periods in ARB's preliminary draft regulations, the general source categories falling under California's cap during the 2012-2015 and 2015-2018 compliance periods, and the 25,000 MTCO₂e threshold at which sources fall under that cap all track WCI's. Both ARB's and WCI's cap-and-trade programs would also commence on January 1, 2012. Of course, ARB has noted that it could shorten its compliance periods to one year or move up coverage of sources in the second compliance period to 2012, which would decrease the similarities between California's program and WCI's.

Federal Requirements

Though it is unclear when the federal government will implement its cap-and-trade program, the American Clean Energy and Security Act of 2009 (commonly referred to as "Waxman-Markey") passed by the U.S. House of Representatives would preempt state and regional programs while accommodating the redemption of allowances issued by California or the WCI.² Once a federal

program is enacted, ARB anticipates linking California's program or transitioning California to the national program.

In the meantime, ARB states its objective of reducing duplicative reporting by working with the U.S. EPA to create a single reporting mechanism that meets both California's requirements and EPA's recently finalized federal mandatory GHG reporting requirements. EPA's reporting scheme also uses a threshold of 25,000 MTCO_{2e}, and it covers many of the same entities that must report under California's reporting rules.³ Yet there are differences in the types of covered sources, as municipal solid waste landfills, for example, must report under EPA's regulations but need not report under California's.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 California Air Resources Board, Overview and Preliminary Draft Cap-and-Trade Regulation to Reduce Greenhouse Gas Emissions in California, *available at* <http://www.arb.ca.gov/cc/capandtrade/meetings/121409/pdr.pdf>.

2 See H.R. 2454, 111th Cong. §711 (2009) (proposing CAA §790(a)).

3 See *generally* Mandatory Reporting of Greenhouse Gases, 74 Fed. Reg. 56260 (Oct. 30, 2009).