

## *Developments in California Cap-and-Trade Regulation*

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On March 28, 2012, two environmental organizations filed a lawsuit challenging the Cap-and-Trade Regulation adopted by the California Air Resources Board (CARB). The suit, which is the first one filed since CARB's adoption of the program, only seeks to enjoin the use of offsets to meet covered entities' compliance obligations. Because it does not seek to prevent the Cap-and-Trade program from being implemented with respect to capped sectors, this lawsuit is unlikely to delay or halt implementation of the program. By eliminating one of the program's primary cost-containment mechanisms, however, the suit could significantly increase compliance costs for capped sectors.

On the day before the suit was filed, CARB's Chairman, Mary Nichols, announced in a Senate hearing that the first auction of greenhouse gas (GHG) allowances, scheduled for August 2012, will only be a "pretend" auction, rather than an actual auction of allowances in which real dollars change hands.

On March 30, 2012, CARB released a discussion draft of amendments to the Cap-and-Trade Regulation to allow for use of compliance instruments from "linked" jurisdictions, which, at this time, is only contemplated to include Quebec. The discussion draft also proposes several changes to the existing Regulation, including significant changes to program elements designed to prevent market manipulation.

### **Citizens Climate Lobby and Our Children's Earth Foundation v. CARB**

The lawsuit, filed in San Francisco Superior Court (No. CGC-12-5195544), marks the first challenge to be filed with respect to California's groundbreaking, economy-wide Cap-and-Trade program which was finalized last year pursuant to the California Global Warming Solutions Act of 2006 (AB 32). The program establishes an overall limit on GHG emissions from capped sectors in California, and entities subject to the cap (covered entities) must surrender "compliance instruments" equivalent to their GHG emissions to CARB.

Compliance instruments include both allowances, which are allocated by CARB or obtained from auctions, and offset credits, which represent lower cost reductions achieved in sectors that are not subject to the cap. The Cap-and-Trade Regulation permits entities to surrender offsets to meet up to eight percent of their triennial compliance obligation. Each offset credit is equal to one allowance (i.e., one metric ton of carbon dioxide equivalent (MTCO<sub>2</sub>e)) and can be issued by CARB for achieving emissions reductions through implementation of an offset project pursuant to one of CARB's approved compliance offset protocols. At present, there are only four approved protocols – Livestock Projects, Ozone Depleting Substances Projects, Urban Forest Projects and U.S. Forest Projects – each based upon the protocols initially developed by the Climate Action Reserve and its predecessor, the California Climate Action Registry.

Petitioners allege that the offset protocols do not adequately assure that the reductions achieved are truly in addition to any GHG reduction that would otherwise occur, as required by AB 32. They contend that CARB's "Performance Standard" approach, where an activity can qualify for offset credit by meeting a

threshold that is merely “significantly better than average” or “beyond common practice”, is inherently flawed. For example, with regard to the ozone depleting substances (ODS) protocol, Petitioners contend that CARB severely underestimated the quantity of ODS currently being destroyed in the marketplace. Similarly, they also contend that reforestation and improved forest management practices have occurred and will continue to occur, without the incentive of the offset payments generated by the U.S. Forest Protocol.

Whether a reduction is “additional” is a difficult question precisely because it is inherently counter-factual: would the activity occur without the additional revenue generated from the sale of an offset? CARB’s “Performance Standard” approach represents the prevailing consensus about how to answer this question and assure the environmental integrity of offsets. While CARB should be afforded some discretion to apply its technical expertise in this respect, it remains to be seen whether the court will agree that the Performance Standard approach or the individual offset protocols adequately satisfy AB 32’s mandate.

Because the Cap-and-Trade Regulation includes a severability clause, even if the lawsuit is successful, it should not prevent the program from being implemented with respect to capped sectors. That said, offsets are one of the most important cost-containment mechanisms CARB included in the program design. Thus, although Petitioners’ suit does not seek to enjoin the program from moving forward with respect to capped sectors, it could have serious and substantial cost implications for covered entities.

### **Delay in First GHG Allowance Auction**

This lawsuit was filed the day after Mary Nichols, Chairman of CARB, testified before the California Senate Select Committee on the Environment, the Economy, and Climate Change. During her testimony, Chairman Nichols announced that the first auction of GHG allowances, which is scheduled for August 2012, will be a fully simulated auction with no consequences, and the first real auction of GHG allowances will take place in November 2012. While this will allow CARB the opportunity to test the auction platform, Chairman Nichols indicated that the delay would not further postpone commencement of the Cap-and-Trade Regulation’s first compliance period on January 1, 2013.

The first compliance period was supposed to begin in 2012. However, last year, due to setbacks CARB experienced in developing the Cap-and-Trade Regulation as a result of an injunction issued in litigation concerning CARB’s approval of the AB 32 Scoping Plan, Chairman Nichols announced that the first compliance period would be postponed until 2013 and that two auctions would be held in 2012 instead as a “road test” of the system. Now, however, CARB has decided that the first of those two test auctions will merely be a simulated auction. While CARB’s announcement might create additional uncertainty regarding whether CARB is, in fact, on-track to launch the program on schedule, it should provide some comfort to auction participants that they will have the ability to see how the auction platform works – and to assure that it actually does work – before real dollars start trading hands.

### **Discussion Draft of Proposed Amendments**

At the time it finalized the Cap-and-Trade Regulation last year, CARB already anticipated amending the final Regulation in 2012 to authorize “linkage” with other jurisdictions participating in the Western Climate Initiative to form a regional trading program. At this time, the only other jurisdiction that has adopted a program ready for linkage with CARB’s program is Quebec. Once the linkage is authorized, compliance instruments issued by Quebec could be used for compliance with the CARB program and vice versa. Additionally, California and Quebec would hold joint auctions of allowances.

Upon approving the final Regulation, CARB’s board also directed staff to continue working with stakeholders to address problems with certain program elements intended to prevent market manipulation, including the allowance holding limit and auction purchase limits. On March 30, 2012, CARB staff published a discussion draft of proposed amendments to link and harmonize California’s and Quebec’s programs by making several changes, including:

- Elimination of “beneficial holding” provisions, whereby investor-owned utilities could purchase allowances on behalf of contracted generators, without the allowances counting against the utility’s own holding limit;
- Providing a process for requesting a temporary adjustment to the limited exemption from the holding limit in years in which the current year’s emissions exceed the prior year’s emissions; and
- Subjecting the investor-owned utilities to an auction purchase limit of 40%
- Comments can be submitted through April 13, 2012 at:  
<http://www.arb.ca.gov/cc/capandtrade/comments.htm>.

## Conclusion

Because the Petitioners’ lawsuit does not take aim at the overall Cap-and-Trade Regulation, it is unlikely either to delay start of the first compliance period on January 1, 2013 or to halt program implementation with respect to capped sectors. If successful, however, this lawsuit could preclude covered entities from using offset credits to meet their compliance obligations, which could significantly increase their overall compliance costs.

The delay in the first actual auction of GHG allowances not only provides an opportunity for CARB to assure that the auction platform works; it also affords more time for the State to decide what to do with the auction revenue. According to the Legislative Analyst’s Office, these auctions are estimated to generate between \$660 million to \$3 billion for the 2012-13 budget year. The Governor’s budget for 2012–13 assumes that the state will receive \$1 billion from such auctions. Of this amount, \$500 million will be used to offset existing General Fund costs of current GHG mitigation activities, and the remaining revenue will be used on new or expanded programs intended to reduce GHG emissions.

CARB need not complete linkage with Quebec (or any other jurisdiction) for the program to be launched as-planned. While a regional program should provide greater liquidity in the market for compliance instruments and thereby reduce costs, a program limited to just California and Quebec may not necessarily do so. Indeed, the Legislative Analyst’s Office has suggested that, to the extent the Quebec cap is more stringent, linkage could result in increased costs to California entities. Thus, significant questions remain regarding, not only whether such an international compact is authorized under the U.S. Constitution, but whether such a linkage makes sense in the first place.



*Paul Hastings Environment and Energy lawyers are deeply involved in development and implementation of CARB’s Cap-and-Trade program. 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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