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Court Upholds Use of Offset Credits in California's Cap-and-Trade Program

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Introduction

On January 25, 2013, the San Francisco Superior Court, Judge Ernest Goldsmith presiding, denied a challenge to the California Air Resources Board's (CARB) Cap-and-Trade Regulation. *Citizens Climate Lobby and Our Children's Earth Foundation v. CARB*, Cal. Super. Ct., No. CGC-12-5195544 (Jan. 25, 2013). The lawsuit sought to invalidate the use of a standards-based approach for determining whether projects should be awarded offset credits, which can be used by entities subject to the Cap-and-Trade Program to meet a portion of their obligation. While the Court's decision represents a significant victory for CARB, it does little to assure that a robust supply of offsets will be available to meet demand, at least during the early years of program implementation.

Background

The Cap-and-Trade Regulation establishes an overall limit on greenhouse gas (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 tradable permits that are equal to the cap, and offset credits, which represent GHG reductions achieved in sectors that are outside of the cap. Each offset credit is equal to one allowance (i.e., one metric ton of carbon dioxide equivalent (MTCO2e)) and can only be issued by CARB for achieving emissions reductions through implementation of an offset project pursuant to one of CARB's approved compliance offset protocols. Currently, there are four approved offset protocols: Livestock Projects, Ozone Depleting Substances Projects, Urban Forest Projects, and U.S. Forest Projects. Covered entities can meet up to 8% of their compliance obligation through use of offsets.

The Legal Challenge

The state law authorizing CARB to create a cap-and-trade program—AB 32—requires GHG reductions under any cap-and-trade program to be "in addition to…any other [GHG] emission reduction that would otherwise occur." California Health & Safety Code § 35862(d)(2). This case, brought by two environmental groups philosophically opposed to emissions trading programs, concerns how CARB satisfied this statutory mandate. In particular, Petitioners Citizens Climate Lobby and Our Children's Earth Foundation challenged the Cap-and-Trade Regulation's offset protocols, alleging that AB 32 foreclosed CARB's use of a standards-based approach.

As the Court observes, demonstrating the "additionality" of reductions has proven difficult under other GHG reduction programs, most notably the United Nations Framework Convention on Climate

Change's (UNFCC) Clean Development Mechanism (CDM), because it is inherently a counter-factual question: would a project achieving reductions have gone forward without the additional revenue obtained through sale of an offset?[1]

CARB's Cap-and-Trade Regulation defines emissions reductions as additional if they "exceed any [GHG] reductions or removals that would otherwise occur in a conservative business-as-usual scenario." Cap-and-Trade Regulation, 17 Cal. Code Reg. § 95802(a)(4). In turn, a business-as-usual scenario is "the set of conditions reasonably expected to occur within the offset project boundary in the absence of the financial incentives provided by offset credits…" *(id.* § 95802(a)(34)) and "[c]onservative means, in the context of offsets, utilizing project baseline assumptions, emission factors, and methodologies that are more likely than not to understate net GHG reductions…for an offset project…" *Id.* § 95802(a)(58).

Petitioners did not challenge these definitions, but rather contended that the four approved offset protocols, each in their own way, failed to ensure that the reductions will, in fact, be additional. Statement of Decision, at 12, 21. CARB's protocols—and the Climate Action Reserve protocols that served as their basis—use a standardized approach to determine whether a type of offset project is additional and then employ project-by-project mechanisms to quantify the actual reductions from particular projects. *Id*. at 12. Petitioners argued that this "standards-based approach" transgressed CARB's authority under AB 32 because it allowed non-additional reductions, *e.g.*, trees that would have been planted by utilities in any event or digesters that would have been installed by dairies to avoid nuisance claims or water pollution, to qualify for offset credits. *Id*. at 21. As the Court put it, the heart of Petitioners' objections was that, by allowing non-additional reductions to qualify as offsets, the price of offsets would plummet, causing capped industries to rely upon illusory reductions rather than make real reductions, thereby defeating AB 32's goals. *Id*. at 6.[2]

The Standard of Review and Decision

The Court decided that, in light of the importance of additionality to assuring AB 32's goals of achieving emissions reductions, it would apply the less deferential *de novo* standard to the question of "whether the legislature delegated to [CARB] the authority to use a standards-based approach to determine additionality." *Id.* Despite applying this standard, the Court ultimately found that CARB's use of a standards-based approach is consistent with AB 32. *Id.* at 25. As the Court states, "[t]he Legislature gave no indication as to a preferred additionality mechanism, only that there must be one." *Id.* at 23. Dismissing Petitioners' reliance on precedent concerning a ban on importing products containing "any" kangaroo, the Court essentially found that, while it is easy to determine whether a product contains any kangaroo, it is not so easy to determine whether a reduction is additional and AB 32 provided CARB the latitude to make this determination. *Id*.

The Court also dismissed Petitioners' attempts to call into question the additionality of specific projects; according to the Court, "[w]hether a particular digester, ODS program, or tree is additional has no bearing on whether the Legislature delegated to respondent the power to use a standards-based approach." *Id*. at 24. Underscoring the importance of what was at stake, the Court said that, if it were to decide that CARB transgressed its authority every time a credited reduction proved to be non-additional, "[CARB] would have to abandon any use of offsets, and perhaps the entire cap-and-trade program." *Id*. At bottom, according to the Court, what Petitioners sought was for the Court to "[r]ewrite the statute to forbid the use of offsets" (*id*.), which it could not do.[3]

The Court's decision to apply the less deferential *do novo* standard to the fundamental question and to nevertheless find, after a close examination of the record, that CARB's standards-based approach was consistent with AB 32 may better insulate the decision from an appeal. On the contrary, it might also provide Petitioners hope that appealing—which they will have until March 26, 2013 to do—will result in a more sympathetic set of eyes and a reversal on this central holding.

It should not be lost on Petitioners, however, that this decision was issued by the same judge who previously dealt CARB a major setback in halting development of the Cap-and-Trade Program (in a case concerning whether CARB had adequately considered alternatives to cap-and-trade in its initial Scoping Plan and largely concerning the problems with emissions trading programs and offsets).[4] Given that Judge Goldsmith had previously shown little sympathy to CARB's development of the program, his decision to uphold CARB's approach in this case should only serve to underscore its own rootedness in application of the appropriate legal standard to the facts.

Conclusion

The decision in *Citizens Climate Lobby* is a victory—both for CARB and for its supporting Intervenors—because allowing covered entities to satisfy their compliance obligation with up to 8% offsets represents one of the Cap-and-Trade Program's primary cost-containment mechanisms. Coupled with the successful first auction for allowances in November 2012 (in which all of the 2013 allowance were sold), this decision upholding a central element of the Cap-and-Trade Program should provide a welcome shot in the arm to CARB's efforts, notwithstanding other pending litigation challenging the authority of CARB to hold an auction in the first place.[5]

The decision does little, however, to assure the existence of a robust offsets supply. Even before the lawsuit was filed, a shortfall was projected, at least for the first few years of the Cap-and-Trade Program's implementation. While this ruling should at least remove the uncertainty that clouded the nascent offsets market over the past several months, as both project developers and covered entities may have found it difficult to invest in offsets while their validity remained in doubt, CARB still has much work to do to develop additional offset protocols, begin issuing offset credits and fully realize their cost-containment potential within the program.

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Paul Hastings Environmental and Energy lawyers are deeply involved in the development and implementation of California'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 San Francisco lawyers:

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[1] The Court pointed out the elusive nature of additionality under even the CDM's project-by-project approach, where satisfying the so-called "barrier" test or "investment" test involves inherently subjective and vague questions, such as whether a given internal rate of return would be inadequate to cause a project to be built, but for the additional revenue stream provided by the sale of offsets. *See* Statement of Decision, at 8-11. Given the problems with the CDM's project-by-project approach, the Court found, in a finding that strongly presages its ultimate decision to uphold CARB's approach, that CARB's rejection of the CDM approach was both warranted, in light of the associated administrative complexity, delay and cost, and consistent with CARB's legislative grant of discretion. *Id*., at 11.

[2] The Court noted that, even if Petitioners' concerns were valid, CARB designed its program so that offsets could not be relied upon for more than 85% of the required reductions, eliminating the risk that the standards-based approach would completely displace actual reductions within capped sectors. *Id*.

[3] Applying the highly deferential arbitrary and capricious standard, the Court also rejected several specific challenges to each offset protocol's capacity to effectuate AB 32's goals. *Id*. at 26-27. The Court refused to wade into the detailed factual questions of whether, for example, cities would continue planting trees or appliance manufacturers would continue recovering and destroying ODS in the absence of offset revenue, and instead "defer[red] to [CARB's] expertise, experience, and sweeping grant of law-making powers." *Id*., at 30.

[4] *Association of Irritated Residents v. CARB*, No. CPF-09-509562 (Cal Super. Ct., Jan. 24, 2011); No. A132165 (Cal. App. 1st Dist., Jun. 19, 2012).

[5] *California Chamber of Commerce v. CARB*, No. 34-2012-80001313 (Cal. Super. Ct., filed Nov. 13, 2012) (challenging CARB's authority to conduct allowance auctions in which it is a participant).