California Adopts Greenhouse Gas Cap-and-Trade Program

On October 20, 2011, the California Air Resources Board (CARB) unanimously approved California's greenhouse gas cap-and-trade regulations—a key measure to implement the state's landmark AB 32 climate change legislation. The new carbon trading program is only one element of California's overall strategy to reduce carbon emissions to 1990 levels by the year 2020. Other components include renewable electricity, low-carbon fuels, and ultra-clean cars. Some estimate that $10 billion in carbon allowances will be traded through the California market by 2016. This would make it the second-largest carbon trading market in the world behind the European Union.

Background

AB 32, the Global Warming Solutions Act of 2006, committed the State of California to an ambitious goal of reducing the state's greenhouse gas emissions to the amounts emitted in 1990. The reduction to 1990 levels is to be achieved by 2020. This is an estimated 15 percent reduction over what emissions would be in 2020 under the so-called 'business as usual' scenario. AB 32 allowed—but did not require—CARB to establish a "system of market-based declining annual aggregate emission limits" for sources of greenhouse gas emissions. In October 2010, CARB elected to proceed with a cap-and-trade emission trading program, in lieu of other options such as a simple carbon tax.

Basics of the Cap-and-Trade Program

Who is Covered? The cap-and-trade program will cover 360 businesses operating some 600 facilities in California that together emit 85 percent of the state's greenhouse gases. Since 2009, each of these businesses has been required to report their annual greenhouse gas emissions to CARB. Beginning in 2013, any industrial source and any electric utility that emits more than 25,000 metric tons of greenhouse gases per year will be required to participate in the cap-and-trade program. In 2015, distributors of transportation fuels, natural gas, and other fuels will join the program. These entities are referred to in the cap-and-trade regulations as 'covered entities'.

Allowance Certificates. CARB will issue 'allowance' certificates which authorize the holder to emit a fixed amount of greenhouse gases. CARB has capped the total number of allowance certificates that will be issued for any given year. A key feature of the program is that this cap will steadily decline through 2020. As the cap declines each year, the number of allowances will decrease and companies will have to find

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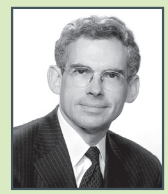

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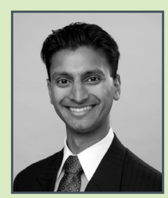

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ways to reduce emissions at their own facilities and/or purchase 'offset credits.'[1]

Offsets and the Auction Process. For 2013, CARB will initially allocate 90 percent of the allowance certificates to covered entities for free. The covered entities can then sell these certificates or purchase additional certificates at auction.[2] At each auction, CARB will sell part of the remaining allowances for current and future years. Companies that generate voluntary reductions in greenhouse gases (beyond what is required by law) can sell offset credits. Disclosure requirements and agency enforcement are intended to assure the integrity of the marketplace for allowances. To ensure price stability, CARB will maintain a certain number of allowance certificates in reserve. Allowance certificates from this reserve will be sold when the auction price exceeds a certain threshold. That threshold is $10 per allowance (one metric ton of emissions) for auctions conducted in 2012 and 2013.[3] Similarly, to prevent monopolies, the regulations prohibit any single company from holding more than a set number of allowances at any time. The regulations also include stiff penalties and fines for non-compliance.

Litigation

Shortly after the cap-and-trade program was announced in December 2010, several environmental justice groups sued CARB. The lawsuit alleged that the agency did not properly consider alternatives to cap-and-trade, as required by the California Environmental Quality Act (CEQA). In March 2011, the California Superior Court ruled for the plaintiffs and enjoined implementation of the cap-and-trade program. However, CARB appealed and on June 3, 2011, the Court of Appeals lifted the injunction, but it did not rule on the merits of the case. CARB then undertook further studies of alternatives under CEQA and reaffirmed its determination that a cap-and-trade program was the best means of achieving the greenhouse gas emissions reductions mandated by AB 32. In September, the California Supreme Court affirmed the decision to lift the injunction. The case remains before the Court of Appeals on the merits.

Flexibility

CARB's adoption of the cap-and-trade regulations comes after three years of research and analysis, numerous public hearings, litigation, and several revisions to draft rules. CARB is well aware of some of the shortcomings of other Clean Air Act programs that authorized pollutant trading. The agency has said that it designed the AB 32 program to avoid past problems. CARB also anticipates that the program will evolve considerably in the coming years. The agency has adopted an 'Adaptive Management Plan' to allow it to respond quickly to issues as they arise.

Next Steps

The regulations have been submitted to California's Office of Administrative Law, which has until December 13 to approve the rules for compliance with California's Administrative Procedures Act. If approved, the regulations will become effective on January 1, 2012.

If you have any questions about any of the topics discussed in this Advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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1 An offset credit reflects a permanent reduction in greenhouse gas emissions from a non-participating entity. Emissions reductions for offset credits are verified by independent entities in accordance with several Offset Compliance Protocols. Offset credits may only be used for 8 percent of covered entity's emissions.

2 The first two auctions will be held on August 15 and November 14, 2012, and then quarterly thereafter.

3 The threshold increases annually thereafter by formula.