

Climate Change Regulatory Alert



The American Clean Energy and Security Act of 2009:

More Detailed Discussion of Key Issues Under Consideration

On April 21, 2009 the House Subcommittee on Energy and the Environment and the Energy and Commerce Committee commenced joint hearings on the “discussion draft” of “The American Clean Energy and Security Act of 2009 (ACESA),” comprehensive energy and climate change legislation that was released on March 31, 2009, by Rep. Waxman (Chairman of the Energy and Commerce Committee) and Rep. Markey (Chairman of the Energy and Environment Subcommittee). A copy of the discussion draft can be found at http://energycommerce.house.gov/Press_111/20090331/acesa_discussiondraft.pdf.

ACESA is comprehensive clean energy legislation and would, among other things, create a nation-wide cap-and-trade GHG emission reduction program. While many of the program elements are very targeted and proscriptive in nature, certain fundamental issues remain unaddressed or unresolved. Among the most significant are:

- The allocation of allowances and distribution of revenues from the auction of allowances;
- The framework of the “offsets” program, including ensuring that program uncertainties that could pose significant barriers are replaced by provisions promoting the development of offset-generating projects, limits on credits available from offsets, the scope of the additionality qualifier, appropriate limits on the cap and use of offsets (including international offsets), and credit for early action;
- How ACESA will work in the context of state and regional climate change programs and whether and how it influences the ability of EPA to regulate GHGs under existing Clean Air Act authorities;
- The proper entity(ies) for overseeing and regulating carbon markets, and the scope of its regulatory authority;
- The question of rebates, eligibility for such rebates and their WTO consistency; and
- The operation, pricing and WTO consistency of the proposed “reserve allowance mechanism.”

Analysis and Discussion of Key Issues

Allocation of Allowances. Title III of ACESA establishes a new Title VII of the Clean Air Act that creates a cap-and-trade GHG emission reduction program that covers electric utilities, oil companies, large industrial sources, and several other categories of sources that emit greater than 25,000 tons per year of CO₂ equivalent (“covered sources”). The legislation sets national reduction targets of 20% below 2005 levels by 2020 and 83% below 2005 levels in 2050. Covered sources will be required to hold emission

allowances for each ton of CO₂ equivalent emitted during the prior calendar year. The ACESA legislation specifies how covered sources will be required to hold allowances to satisfy the cap-and-trade requirements. It is not clear how those allowances originally are to be disbursed (i.e., allocated or auctioned) or how any resulting revenue would be directed.

The legislation includes only a “to be supplied” notation with respect to the allocation vs. auction issue. Contrast this with the publicly announced preference of the Obama Administration for auctioning 100% of the allowances; legislation recently introduced by Rep. Van-Hollen (D-MD) also calls for auctioning 100% of the allowances.

This critical component has generated significant discussion and debate in academic circles as well as in Congress. Advocates of auctioning a significant portion of the allowances argue that doing so avoids a private windfall to certain commercial sectors and generates revenue that can be used to achieve policy objectives for the public good; those who favor allocating allowances to covered sources, without cost, argue that doing so is essential to avoid price spikes that could threaten the viability of the cap-and-trade program.

Ultimately, how allowances are distributed likely will be answered as a matter of political deal making—what system will attract the requisite number of votes in Congress—rather than in the context of what best serves the goals of the cap-and-trade program. Reserving this issue ensures that the political debate that will be necessary to move in one direction or the other will occur over the next three weeks, and assuming that the final outcome has some allocation element, it also sets up the further debate regarding how to allocate or distribute allowances among the covered sources.

If there is an auction, any legislation must also address how resulting revenues are to be distributed. The relevant provision in ACESA merely indicates that there will be “other funds to be supplied” that will presumably contain direction as to how to spend those revenues. Again, contrast this to both the Van-Hollen bill (which would apply the proceeds first to cover the administrative costs of the program, with the remainder to be used for “consumer protection” programs) as well as the Lieberman-Warner Climate Security Act of 2008 (S.3036), which specifically identified the programs to be funded by these revenues, down to the tenths of a percent.

A number of programs created by ACESA would be logical recipients for auction revenue—programs seeking to promote clean energy and consumer protection, as well as adaptation funds, and funds to support the international deployment of clean technologies in developing countries that have ratified an international treaty and undertaken nationally appropriate mitigation activities. Because the potential size of the revenue pot to be distributed is so large (approximately \$645 billion over seven years, according to some estimates), this debate might be even more contentious than that over auction vs. allocation. This issue alone could bog down the legislation as Congress lines up to direct expenditures of vast sums of money not unlike the Congressional appropriations process.

As ACESA moves through subcommittee hearings and markups, these are likely to be two of the biggest, most-debated topics; they are, however, fundamentally different from many of the other significant questions that will be debated in that (a) there is no “starting point” from which to begin the debate—anything is possible, and (b) they are, in effect, zero-sum game issues, in that each decision will produce an economic winner and an economic loser.

Offsets. The subject of “offsets” is a controversial one that has been debated and will continue to be debated both with respect to domestic and international climate change efforts. Offsets are GHG reductions resulting from project activities undertaken by third parties and sold or transferred to covered sources. Offsets may provide both flexibility and cost-containment in cap-and-trade programs—covered sources can choose between reducing their own GHG emissions or financing projects undertaken by third parties in return for the offsets, a decision which is made largely, if not solely, on financial grounds. Offsets have been a staple of the Clean Development Mechanism (CDM) under the Kyoto Protocol; however, the CDM experience has been cited by both proponents and opponents of offset programs.

The debate over offsets includes questions about the verifiability and permanence of GHG reductions and over issuing offsets for reductions from project that would be undertaken anyway in a “business as usual” scenario (additionality). There is also a broader policy question about the potential that allowing offsets actually creates a disincentive for a domestic covered source to implement GHG reduction projects because of the abundance of cheaper and easier offset-generating projects in developing countries.

In contrast to ACESA’s silence about the distribution of allowances, Part D of the new Title VII sets forth prescriptive requirements for the creation, approval, verification, use and transfer of offsets. Covered sources would be allowed to use offsets to meet their compliance obligations; there is an aggregate annual national cap on the volume of creditable offsets (2 billion tons, split between offsets generated domestically and internationally). Further, a covered source seeking to offset emissions would be required to surrender 5 tons of offset credits for each 4 tons of emissions offset.

ACESA requires EPA to promulgate regulations establishing the parameters of the offsets program within two years of enactment, taking into account recommendations from an advisory board on issues such as the types of projects that are eligible for creating offsets and the methodologies for addressing such issues. The legislation sets minimum requirements for additionality, baselines, measurement and leakage.

Several topics are likely to generate significant debate.

- **Uncertainties threaten future of offset projects:** Experience has shown that the greatest barrier to CDM projects is uncertainty faced by project proponents and funders, including uncertainties regarding the eligibility of projects, the complexity of the process and the timeliness of approval/verification. It is unlikely that EPA’s rules for the offsets program will be finalized for at least two years following enactment of ACESA; uncertainty regarding fundamental elements of the program is likely to soften the market for offset projects in the near term. For example, the legislation does not specify or clarify the types of reduction/avoidance projects that would be eligible for offsets. Also, EPA’s regulations will establish approval and verification procedures that each proposal for offsets must go through, including an administrative petition process for approval of a project and independent third party verification requirements. While the statute calls for EPA to act on petitions and verification reports within 90 days of submission, experience suggests this timeline may not be realistic.
- **The equities of discounting offsets:** Requiring covered sources to secure offsets that exceed emissions by a 1.25:1 ratio may not be fair for projects that already have gone through an approval/verification process. Any discount will reduce the incentive to fund offset projects, thus reducing the number of offset projects undertaken and limiting the flexibility that the offset program is designed to promote.
- **The definition of additionality:** the legislation specifies that at a minimum EPA’s regulations must consider reductions to be additional only if they are not required by or undertaken to comply with any law or regulation AND the project was not commenced prior to January 1, 2009 AND they exceed reductions from conservative business-as-usual performance or practices. Uncertainty regarding the definition and ultimate application of the additionality qualifier, especially with respect to what constitutes “business-as-usual,” will reduce incentives for project proponents and funders.
- **Limit on the overall volume of offsets that can be used annually:** Where this number should be set is already the subject of advocacy by both environmental public interest groups (who contend the 2 billion number is too high and will delay domestic reduction projects) as well as covered sources (who say it is too low to provide meaningful flexibility, especially with respect to the 1 billion limit for international offsets, which is where most eligible offsets likely will originate in the short term).
- **Limits on use of offsets to meet compliance obligations:** Covered sources will be limited in their ability to use offsets to meet compliance obligations. Pursuant to a formula in ACESA, covered sources may only use offsets to cover approximately 30% of their compliance obligations for the first year; the formula ratchets down that percentage as the overall cap on GHG emissions tightens over time. This may cause

companies to rethink funding the development of technologies for future offset projects, such as carbon capture and sequestration, where the technology may not be commercially deployable for several years.

- Limits on credit for early offsets: The legislation places a series of limits on the eligibility of reductions/avoidance from projects commenced prior to enactment of the legislation. For example, projects that generated credits under state regulatory and/or voluntary GHG programs will only be eligible for offsets under the federal program if the project commenced after January 1, 2001 and the state program pursuant to which the credits were issued was in effect as of January 1, 2009 and meets several other criteria regarding standards, methodologies and protocols.

- Limits on international offset credits: ACESA limits the eligibility of credits for international offset projects to projects undertaken in developing countries that are party to a bi-lateral or multilateral agreement that includes the United States and that includes adequate measures to address international offset credits. It also requires that EPA's regulations identify specific countries and sectors where offsets will only be available on a "sectoral basis," a task that the Agency may not have the resources to complete in a timely fashion.

A viable offsets market is critical to the success of a cap-and-trade program, especially in the interim years before commercially available technological advances make GHG emission reductions feasible. All of these issues, and many others, must be carefully evaluated and analyzed; decisions made in the next several weeks may determine whether such a viable offsets market will exist.

Pre-Emption of State and Regional Programs and Regulation under the Clean Air Act. While the legislation amends the CAA specifically to allow states to implement GHG/climate change regulatory programs, it **prohibits** states and local subdivisions from enacting or enforcing state or local programs that cap emissions of GHGs until at least the year 2018. There are provisions that will allow covered sources that have been issued allowances prior to 2012 under the RGGI program (and potentially under the California program) to exchange those allowances for ACESA allowances to be used in the federal program. While this provision is designed to allow the federal program to grow and mature, as drafted, it initially will subsume both RGGI and the California program. Beginning in 2018, however, states (and, presumably, RGGI) will be authorized to implement and enforce a cap and trade program that is more stringent than the federal program, leading to the potential for multiple and competing requirements on covered sources. The prohibition on state cap and trade programs through 2017 does not extend to programs that seek to establish fleet-wide motor vehicle emission requirements or clean fuel standards.

The legislation also limits EPA's ability to regulate GHGs under existing CAA authority and programs. First, EPA is prohibited from listing GHGs, individually or collectively, as a criteria pollutant under Section 108(a) of the CAA on the basis of its effect on climate change. Second, EPA is prohibited from listing GHGs, individually or collectively, as a hazardous air pollutant under Section 112 of the CAA unless the GHG (or GHGs) meets the Section 112(b) listing criteria independent of its effect on climate change.

Third, the Prevention of Significant Deterioration (PSD) provisions shall not apply to GHGs "solely on the basis of its effect on climate change or regulation under [the new] title VII" of the Clean Air Act. Finally, GHG emissions are not to be considered by stationary sources when calculating emissions or potential emissions for the purpose of determining whether that source is a major source subject to Title V permitting. Those limits provide comfort to those lawmakers who remain concerned about EPA's authority (and desire) to regulate GHGs beyond cap and trade.

Regulation of Carbon Markets. ACESA raises questions about both how to regulate or oversee carbon markets and who the regulator(s) should be.

ACESA would split up oversight/regulatory functions of these markets: the Federal Energy Regulatory Commission ("FERC") would have jurisdiction to regulate and oversee the "spot" or cash carbon trading market, while carbon allowance derivative markets would be subject to regulatory oversight from a "working group" and/or other "appropriate Federal agencies" as directed by the President. The Warner-Lieberman Climate Security Act, on the other hand, would have created a single "Carbon Market

Efficiency Board” that was modeled after the Federal Reserve and that would have been charged with overseeing and regulating carbon allowance markets.

There is a fundamental debate as to the appropriate balance between regulation/oversight and over-regulation. Regulation/oversight is perceived to be necessary to ensure transparency, eliminate counterparty risk, and/or prevent market manipulation; however, there is a danger that over-regulation would stifle trading or effectively eliminate over-the-counter trading by driving all trading to the regulated exchanges. Experience in carbon trading in Europe shows that approximately 70% of trades occur in the over-the-counter market, which argues for establishing a regulatory system that accommodates both exchange and over-the-counter trading. Promoters of carbon reduction projects argue that eliminating over-the-counter trading of carbon derivatives would dampen the development of carbon reduction projects by eliminating potential sources of project financing.

There is also a debate as to whether overall regulatory responsibility for the market will be weakened by dividing oversight responsibility to two different entities. Some argue that a split between FERC (which traditionally regulates spot and forward physical trades) and CFTC (which regulates futures transactions) seems natural, which would bring each entity’s experience and expertise to bear. President Obama’s nominee to head Commodity Futures Trading Commission has weighed in on the question, stating that the CFTC has the “best experience and the regulatory authority” to oversee carbon *futures* markets. There are others, however, who believe that because covered sources will likely make trades in both the spot and futures markets, it would make sense to have one entity oversee both.

In the end, carbon markets are not immune from the prevailing atmosphere regarding market manipulation and the need for transparency in all trading markets, and it does not appear that legislators will allow the carbon markets to regulate themselves.

Competitiveness, Trade and Carbon Leakage. To ensure that U.S. manufacturers are not put at a disadvantage relative to overseas competitors, the draft provides for both a “rebate” and a “border adjustment” or “international allowance” system. First, ACESA authorizes companies in certain industrial sectors to receive “rebates” to compensate for additional costs incurred under the program. Rebates will be distributed annually to the owners and operators of entities in eligible industrial sectors, subject to certain maximum levels. Detailed eligibility criteria remain to be defined, but the draft links ‘presumptive eligibility’ to greenhouse gas and trade intensity. Sectors not ‘presumptively eligible’ may qualify for rebates following an administrative determination based on factors such as the potential for greater foreign sourcing; the effect of international markets on product pricing; the potential for increased net imports or decreased exports; and the state of international climate change negotiations (collectively referred to as the risk of “carbon leakage”).

Second, the draft provides a mechanism to determine whether a sector or sub-sector of the U.S. economy is experiencing “adverse effects” as a result of the domestic cap-and-trade system vis-à-vis foreign competitors. In particular, the mechanism looks at reductions in existing, or failure to initiate or create new, domestic production or jobs; and increases in greenhouse gas emissions by foreign manufacturing facilities not subject to “commensurate obligations”. If such effects are deemed to exist, the President is required to issue regulations putting into place an “international reserve allowance program”, i.e., border adjustments, and importers will be required to purchase carbon allowances to import “covered goods”. The stated purpose of the program is to offset any competitive disadvantage that U.S. manufacturers may experience as a result of compliance with a U.S. cap-and-trade program.

The rebate and international allowance systems leave a range of practical and legal questions unanswered. The rebate program, for example, will likely trigger active lobbying from companies and business groups attempting to comply with and shape—as yet largely unspecified—eligibility requirements. Recent European experience with companies and sectors lobbying for exemptions from the revised European Emissions Trading System illustrates the importance of this issue and the debate it is likely to engender. The same is true for the proposed border adjustments. How, for example, are “commensurate obligations” established; what criteria will be applied to determine whether “adverse effects” exist; and how will “international reserve allowances” be priced? Furthermore, while the proposed reserve allowance

mechanism has clearly been devised with core World Trade Organization (WTO) rules in mind, many questions of WTO consistency remain unresolved and will likely continue to feature prominently in further discussions about the legislation.

Conclusion

These and many other significant components of ACESA will be the subject of hearings over the next several weeks. According to a preliminary schedule, the Energy and Commerce Committee hopes to complete consideration of the ACESA by the end of May, with hearings and the full Committee markup set for the week of May 11. There are several other Committees and Subcommittees in the House that are planning to have hearings on and, in some instances, may seek jurisdiction over, specific portions of what is in ACESA. Because ACESA is so broad and includes provisions addressing energy/renewable energy, "taxes" or revenue, stimulus-type grant programs, etc., these and other elements of ACESA may become the subject of competing legislative processes on the House side. In addition, the Senate will also be seeking to move forward on climate change in this Congressional session, likely with the same myriad of issues and jurisdictional challenges.

For now, however, it appears that ACESA will be the main vehicle for energy and climate change discussions in the United States, at least in the near term. Regardless of where these discussions and debates take place, businesses with an interest in these issues should monitor the upcoming activity closely and participate where needed.

Following the hearings that are currently taking place, the Energy and Environment Subcommittee is scheduled to markup the legislation in the weeks to come. Given this ambitious timeline, and the fact that many of these topics are truly open for debate and discussion, now is the time to make sure you identify and fully understand those that are critical to your company.

If you have questions about the legislation or its implications contact one of the authors of this note, or call your WilmerHale Lawyer.

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