Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

CAIR: A Journey Revisited — Part II

Law360, New York (February 27, 2009) -- As we discussed in a previous article ("CAIR: A Journey Revisited — Part 1"), on Dec. 23, 2008, a three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") remanded the Clean Air Interstate Rule ("CAIR") to the U.S. Environmental Protection Agency ("EPA").[1]

With this decision, CAIR remains in place and effective while EPA works to develop a regulation that accomplishes the intended environmental goals while at the same time addresses and remedies the flaws cited by the court in its earlier decision.

Our previous article discussed the impacts of the original decision and the subsequent remand on EPA and state regulatory agencies. In this article we review the impacts on energy companies subject to the CAIR regulation, as well as on the relevant emission markets.

The remand re-imposes a degree of stability and certainty for the regulated community, and for emissions markets, that is very much needed in the aftermath of the decision vacating the rule.

Brief Background

EPA promulgated CAIR in March of 2005. CAIR was designed to assist states in meeting attainment targets for fine particulates (PM2.5) and ozone. CAIR used a two-stage program of statewide SO2 and NOx emission "caps" as well as a model interstate trading program to facilitate compliance with the new emission reduction targets.

On July 11, 2008, the D.C. Circuit vacated CAIR in its entirety, finding "more than several fatal flaws in the rule."[2] The court did not, however, issue the mandate executing the vacatur, and the United States and three other parties moved for rehearing.

The court requested additional input on the issue of whether and how CAIR might remain in effect. Based in large part on the parties' submissions, on Dec. 23 the court remanded CAIR to EPA without vacatur.

The court reasoned that although CAIR was fundamentally flawed, the court wanted to "preserve the environmental values covered by CAIR" while EPA sought to promulgate a regulatory program that was both authorized by and consistent with legal authority under the Clean Air Act.

Implications of CAIR Vacatur and Remand — Energy Companies and Emissions Markets

The implications of the July and December decisions on regulatory agencies were significant. Even more serious implications resulted from the uncertainties faced by those energy companies that owned and operated power plants subject to CAA regulation.

Prior to the vacatur, most of those companies had undertaken multi-year analyses of CAA compliance options, and had made decisions relying on the Clean Air Mercury Rule and CAIR (among other CAA regulatory programs).

Those decisions included whether and when to undertake costly and time consuming pollution control projects, with binding commitments made as part of a broad compliance strategy.

As part of those deliberations, companies developed compliance plans based on certain assumptions regarding the SO2 and NOx trading markets that were based on the expected performance of those markets under CAIR.

When the D.C. Circuit vacated CAIR it, in EPA's words, "upended the settled expectations upon which substantial investment in control equipment and [emission] allowances has already been made, resulting in losses of billions of dollars to regulated companies."[3]

EPA said the decision dramatically affected both the SO2 and NOx emission markets (See Declaration of Brian McLean (director of the Office of Atmospheric Programs at EPA) submitted with petition for rehearing).

EPA proclaimed that vacatur had resulted in significant devaluation in allowance prices for both Title IV SO2 and 2009 CAIR NOx allowances, to the detriment of both sources that had made early reductions and banked allowances and parties that had made allowance trades.

In addition, Mr. McLean pointed out that if CAIR was vacated pending development of new regulations, there would be a significant delay in the pace of actual future emission reductions.

A review of the market statistics demonstrates the impact of the decision. In the SO2 market, 2009 SO2 allowances were selling at between $500 and $1,600 per ton between May, 2005 and July, 2007 (i.e., after promulgation of CAIR).

On July 10, 2008, the price was approximately $300 per ton; on July 11th (the date of the D.C. Circuit decision) the price plummeted to approximately $140 per ton. By July 16th the price was down to a 10-year low of $85 per ton.[4]

The influence on the NOx market was even greater, as the NOx market for annual NOx allowances created by CAIR would have simply ceased to exist as of Jan. 1, 2009, had the D.C. Circuit's vacatur been made effective. Immediately prior to the July 11th decision, 2009 annual NOx allowances were selling at approximately $5,000 per ton; by July 15th the price had declined to $1,000 per ton.[5]

These dramatic price reductions had a direct impact on companies that had developed their multi-year compliance plans and made investment decisions in the 2005-2008 timeframe.

Those decisions were based at least in part on the regulatory and compliance structure set forth in CAIR and adopted by states covered by CAIR, and on the related prevailing and predicted SO2 and NOx allowance prices.

The market conditions that existed during that time period had supported decision to invest early in costly control equipment, in part to ensure compliance with CAIR emission requirements, but also, in part, to generate early action offsets — a stream of excess emissions allowances companiescould sell to recoup their early investment.

EPA estimated that companies in CAIR-covered states spent almost $4 billion on SO2 controls and $1 billion on NOx controls in 2005 and 2006; EPA further projected that over $14 billion in SO2 controls and $3 billion in NOx controls were planned for 2008-2012 prior to the CAIR decision.[6]

When the D.C. Circuit vacated CAIR and the market for SO2 and NOx allowances reacted, those investments were significantly degraded.

Other companies purchased SO2 and NOx allowances as a hedge, expecting that the market would drive prices higher as the CAIR compliance obligations became effective.

In either circumstance, the drop in the price of these allowances resulting from the CAIR decision had a significant adverse impact on the financial position of companies subject to the program.

EPA estimated that in the four months after the CAIR decision, the value of banked SO2 emissions decreased by more than $3 billion,[7] while the aggregate value of 2009 NOx allowances decreased by more than $6 billion.[8]

In addition to the economic impact on companies, the July 11th CAIR decision also had a potential impact on the environment. The type of advanced equipment that controls emissions of SO2 and NOx (i.e., flue gas desulfurization, selective catalytic reduction) is very expensive to install and maintain.

Many of these companies made the decision to invest in this equipment based on their ability to recover at least a portion of these costs through the generation and sale of excess allowances, again calculated based on market conditions assuming the existence of the CAIR regulatory program.

Without CAIR, in many instances there was no regulatory compliance obligation to install or operate these controls. In addition, significantly depressed emission allowance prices in many cases eliminated any economic incentive to operate the equipment that had already been installed, or to complete planned installation and operation (i.e., the operational cost in dollars per ton of pollutant removed exceeded the market price per ton for allowances).

As a result, many companies re-evaluated whether to operate control equipment that was already in place (some were evaluating whether to operate only periodically, as required to meet other compliance obligations, instead of continuously, as originally planned).

Other companies were revisiting commitments to install and operate such equipment in the future, or perhaps delaying installation/operation.

As a result, vacatur of CAIR also jeopardized the significant environmental and health benefits to be realized once CAIR took effect in January 2009 — a point emphasized by Mr. McLean in his declaration.

A review of filings made by utility companies with the U.S. Securities and Exchange Commission in the third and fourth quarters of 2008 reveals both the economic and operational challenges resulting from the vacatur of CAIR. Excerpts from financial statements filed by PPL Corporation and Duke Energy Corporation are illustrative:

PPL

"As a result of this decision, PPL Corporation ("PPL") now anticipates that all of the annual nitrogen oxide allowances PPL EnergyPlus had purchased may be impaired because the CAIR rule has been vacated and therefore these allowances are no longer required.

"In addition, the market price of sulfur dioxide allowances has fallen dramatically since the court's decision was issued. PPL currently is evaluating the court's decision to determine its financial and other impacts.

"The combined book value for these sulfur dioxide and nitrogen oxide emission allowances was approximately $100 million at June 30, 2008, excluding the seasonal nitrogen oxide allowances unaffected by the court's ruling ...

"In addition, as a result of the court's decision PPL is reviewing aspects of its previously announced program to install certain pollution control equipment to meet the CAIR requirements, along with the relevant contracts for the purchase of these allowances."[9]

Duke Energy

"Due to the sharp decline in market prices of SO2 allowances, as discussed above, Commercial Power recorded pre-tax impairment charges of approximately $77 million related to forecasted excess SO2 allowances held at September 30, 2008.

"Additionally, Commercial Power recorded pre-tax impairment charges of approximately $5 million related to annual NOx allowances during the three months ended September 30, 2008 as these were also affected by the decision to vacate the CAIR ...

"Duke Energy's plan in the Midwest had been to spend approximately $300 million between 2008 and 2012 ... to comply with Phase I of CAIR and approximately $200 million in Indiana for CAIR Phase 2 compliance costs over the period 2008-2017. It has not been determined how the court's decision will affect these planned expenditures."[10]

The uncertainty of the regulatory and financial issues that faced companies subject to CAIR in light of the July 11 decision was evident in these and other similar filings.

While the Dec. 23 decision remanding CAIR to EPA provided some much needed relief in the form of temporary regulatory stability, the decision also resulted in market impacts similar in magnitude to those felt in July.

The price of 2009 SO2 allowances rose from approximately $140 per ton immediately before the decision to $220 per ton after, while the price of 2009 NOx allowances rose from approximately $2,000 per ton to $6,000 per ton.[11]

This significant increase in the market price of these allowances had implications for companies subject to CAIR analogous to the precipitous drop in prices in July.

Some companies were holding allowances pending the final resolution of the litigation; the value of those portfolios increased dramatically.

Other companies made the decision to sell allowances or defer making compliance expenditures after the July 11 decision, based on the prospect of no CAIR compliance obligation and/or the ability to purchase allowances at relatively cheap prices; the

market shift in late December had a serious negative financial impact on many of those companies.

The increase in allowance prices also potentially changed the economics for companies that had been re-evaluating their short- and long-term operational strategies vis-à-vis early installation and operation of control equipment.

In some cases the market prices may have increased sufficiently to once again provide a financial incentive to invest the capital to install, operate and maintain the control equipment rather than rely on purchased allowances to meet short term compliance obligations.

Conclusion

The December decision to remand CAIR to EPA is by no measure the end of the story for those subject to CAIR — we will watch how EPA proceeds (with or without Congressional intervention) over the next two years, at least.

But, for those companies looking to the regulatory structure and emission markets for purposes of long-term compliance planning, the December decision at least temporarily brought some much-needed stability.

Whether the decision will result in long-term stability in these markets is an open question, and one that will ultimately be answered in large part by the direction that EPA takes as it moves forward with its response to the remand from the D.C. Circuit.

--By Kenneth R. Meade, Wilmer Cutler Pickering Hale and Dorr LLP

Ken Meade is a partner with WilmerHale in the firm's Washington, D.C., office.

The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] State of North Carolina v. Environmental Protection Agency, No. 05-1244 (D.C. Cir. Dec. 23, 2008).

[2] State of North Carolina v. Environmental Protection Agency, No. 05-1244 (D.C. Cir. July 11, 2008).

[3] United States Petition for Rehearing or Rehearing En Banc at 2 (Sept. 24, 2008), State of North Carolina v. Environmental Protection Agency, No. 05-1244 (D.C.Cir.).

[4] SO2 Markets – July 2008 Monthly Market Update, Evolution Markets (new.evomarkets.com/index.php?page=Emissions_Markets).

[5] Data from Evolution Markets (new.evomarkets.com/index.php?page=Emissions_Markets).

[6] See Declaration of Brian McLean, paragraph 12, page 4, State of North Carolina v. Environmental Protection Agency, No. 05-1244 (D.C.Cir.).

[7] See McLean Declaration, paragraph 11, page 4.

[8] See McLean Declaration, paragraph 15, page 5.

[9] PPL Corporation, Form 8-K, filed with U.S. Securities and Exchange Commission July 11, 2008, Item 8.01.

[10] Duke Energy Corporation, Form 10-Q, filed with U.S. Securities and Exchange Commission Nov. 7, 2008, Notes to Unaudited Consolidated Financial Statements, Item 10 (Impairment Charges).

[11] Data from Evolution Markets (new.evomarkets.com/index.php?page=Emissions_Markets).