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1. EMISSIONS TRADING IN THE US: LEGAL ISSUES¹

A. Introduction

Amid great expectations, the United States ratified the Framework Convention on Climate Change in 1992 but ultimately it declined to ratify the Kyoto Protocol. What began as reluctance by the Clinton administration to submit the Protocol for ratification—stemming in part from a US Senate resolution warning that presenting the Protocol for ratification would be futile²—developed into outright rejection of the Protocol by the subsequent Bush administration. Convinced that legally binding greenhouse gas (GHG) reduction targets would have ‘wrecked’ the US economy,³ former-President Bush instead encouraged a focus on voluntary GHG initiatives. The perception among key state governments and non-governmental organizations that the federal government was shirking its responsibilities, however, led to the initiation of a number of sub-national regulatory initiatives. These initiatives have served to pressure the regulated community and the federal government to consider action domestically and to engage in climate negotiations internationally.

B. Developing Political Trends

The interplay of regulatory activity between the states and the federal government has greatly influenced the development of environmental law in the United States. The political and constitutional challenges of a federal system have been one of the animating features of US environmental law. Climate change is no exception; indeed, because of its scope and breadth, the regulatory response to climate change at the state and federal level will undoubtedly raise unprecedented tensions in the state-federal relationship. At the time of writing (in mid-2009), those tensions are already beginning to emerge. Commitments under several sub-national trading initiatives are gearing up just as Congress and the new administration under President Obama are preparing for national and possibly even international action on climate change. Accordingly, many essential features of US climate policy are in flux, and the precise nature of the interaction between national and sub-national GHG regulation remains uncertain.

C. Trading Schemes

We provide an overview of sub-national trading schemes at the regional and state level, where mandatory regulations creating carbon trading regimes are, as of this writing, most advanced in the United States. The next section surveys a number of legal issues that will play an essential role in the design and implementation of any cap and trade scheme in the United States, whether at the national or sub-national level. We then addresses a series of constitutional challenges specific to state or regional programs that may limit the scope and

¹ Adapted from D. Williamson, et al. "[Legal Aspects of Carbon Trading: Kyoto, Copenhagen, and beyond,](#)" co-author of chapter: "[Emissions Trading in the US: Legal Issues](#)" *Oxford University Press* (October 2009)

² Byrd-Hagel Resolution, S Res 98, 105th Cong (25 July 1997).

³ Associated Press, ‘Bush: Kyoto treaty would have hurt economy’ (30 June 2005) <<http://www.msnbc.msn.com/id/8422343/>>, accessed 2 February 2009.

perhaps the viability of these non-federal programs. Finally, we consider a number of prospective legal issues that are likely to arise in designing a new federal climate change statute, such as the relationship between an emissions trading market and existing US environmental laws and trade policy. This part also identifies the legal issues that may arise in the event that there is no new climate change-specific federal statute adopted, in which case the US Environmental Protection Agency (US EPA) may instead seek to generate a market for emissions trading through regulations adopted under the existing Clean Air Act.

(1) *Sub-National Greenhouse Gas Trading Initiatives*

Although a number of state and regional GHG initiatives have developed independently, the various programs exhibit certain common features, most notably a combination of targeted ‘command and control’ restrictions on carbon emissions and a ‘cap and trade’ approach to limiting emissions from the electric utility sector and other traditional heavy-emitting ‘smokestack’ industries. Building on these similarities, preliminary discussions regarding the eventual merger of the principal regional programs have begun. While there continue to be differences among approaches, there is growing consensus that merging these systems is desirable provided certain design elements can be worked out, such as fair and effective allocation and/or auction of allowances, agreement on which sectors will be covered, and leakage of emissions outside the boundaries of the sub-national program. Whether such details can be resolved before the effort is potentially superseded by a federal program remains to be seen.

(a) *The Northeast Regional Greenhouse Gas Initiative*

The most advanced of these state and regional programs, the Regional Greenhouse Gas Initiative (RGGI), became effective on January 1, 2009 after holding a series of emissions allowance auctions in late 2008. RGGI is a cooperative effort among ten US mid-Atlantic and Northeast states to reduce carbon dioxide (CO₂) emissions from large fossil fuel-fired electric utilities in two stages.⁴ The program caps and stabilizes utility sector emissions at 188 million tons of CO₂ per year (with sub-allocations to individual states) from 2009 through 2014 and then requires a 2.5% annual reduction over four years for an overall 10% reduction by 2018, which is estimated to be approximately a 10% reduction below the region’s 1990 emissions level. RGGI established a Memorandum of Understanding (MOU) among the participating states and adopted a model rule detailing the CO₂ emissions trading program and requirements for offset projects. Although each state must individually adopt the model rule, the program allows flexibility in the implementation of certain design features such as allowance allocation, source exemptions, and permitting.

While RGGI has been applauded as a first mover, it has also garnered criticism for its relatively modest reduction goals and over-allocation of emissions credits, which was compounded by a flurry of early fuel switching (generally from oil to natural gas) by electric utilities and a period of mild winter weather which further reduced fuel combustion demands. At the same time, by precipitating early action within regulated industry in the face of anticipated mandatory GHG cuts, RGGI has arguably accomplished exactly what it

⁴ For further information and the RGGI Model Rule, see <<http://www.rggi.org>>, accessed 10 February 2009. The 10 member states of RGGI are Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, and Vermont.

was designed to do: impose an early market signal to influence behavior within targeted emitting sectors. Notably, the RGGI states anticipate (and indeed, have pushed for) future federal climate legislation, and the MOU provides for transitioning into a federal program provided it is comparable to the goals of RGGI.

RGGI builds on a progenitor in Massachusetts that controlled emissions from the six largest electric generators in that state.⁵ Although the Massachusetts regime was soon superseded when the state joined RGGI, it is worth noting that the program triggered a dispute with the nuclear energy industry, which challenged its exclusion from certain incentives given to low-carbon power sources. Although the suit was eventually dropped, it serves as a harbinger of the broader debate about whether low-carbon but environmentally controversial energy sources, such as nuclear energy and large hydropower, will be given favorable treatment under US climate programs.⁶

(b) California Assembly Bill 32

The momentum for sub-national action was significantly accelerated by California's passage in 2006 of the Global Warming Solutions Act (better known by its Assembly Bill designation 'AB 32')⁷ with the vigorous support of Governor Arnold Schwarzenegger. AB 32 caps state-wide GHG emissions at 1990 levels by year 2020. The law mandates the monitoring and annual reporting of GHG emissions by all sources 'of significance,' and delegates broad authority to the California Air Resources Board (CARB) to develop and implement GHG emission reduction measures in accordance with an aggressive series of deadlines, including final regulations to set GHG 'emission limits and emission reduction measures' by 1 January 2011. The AB 32 emissions regulations will become operative as of 1 January 2012, just as commitments under the Kyoto Protocol are winding down.

Significantly, AB 32 does not mandate that CARB use a market-based system for complying with the carbon emission limits.⁸ AB 32 instead delegates that fundamental decision to CARB, which was directed to prepare a Scoping Plan detailing the strategies California will use to reduce GHGs, and then to issue programmatic regulations. Among the potential strategies that may be considered are market-based compliance mechanisms such as a cap-and-trade program.

Although CARB has not yet finalized the regulations implementing AB 32, it approved the Scoping Plan in December of 2008. The plan adopts a mix of command and control regulations combined with a market-based cap-and-trade regime. The cap covers

⁵ For further analysis on the Massachusetts Greenhouse Gas Initiative ('MGGI') see Beveridge & Diamond, PC, 'Massachusetts Adopts Greenhouse Gas Trading Program' (24 October 2006) <<http://www.bdlaw.com/news-news-archive-83.html>>, accessed 2 February 2009.

⁶ See *Entergy Nuclear Generation Co v Massachusetts Dept of Env't Protection*, No 04-4643-A (Mass Super, filed 21 June 2007).

⁷ Cal Health & Safety Code §§ 38500–99 (2006).

⁸ Although the California law expressly provides that CARB may employ market mechanisms, the definition of 'market-based compliance mechanism' allows for a system other than a carbon dioxide emission cap-and-trade system. See *ibid* §§ 38505(k), 38562(c), and 38570.

approximately 85% of California's emissions and extends to the electricity, transportation fuels, natural gas, and industrial emitting sectors.⁹ The plan includes a trading component, but initial trading will involve only electricity generators and large industrial facilities (with annual emissions greater than 25,000 metric tons of CO₂e). The plan incorporates auctioning of allowances and limited use of offsets (both within and outside of California) and will be designed to inter-operate with the Western Climate Initiative.

(c) The Western Climate Initiative

Inspired by California's lead, a coalition of US states and Canadian provinces have formed an alliance known as the Western Climate Initiative (WCI). WCI's goals are to establish mandatory reporting of GHG emissions, impose regional limits on emissions, expand the market for carbon trading, and contain the vexing problem of 'leakage,' whereby GHG emissions tend to increase in areas outside the regulated emissions cap.¹⁰ WCI participants are now recommending a regional cap-and-trade program that would cover approximately 90% of GHG emissions in the region.¹¹ The program is scheduled to operate in phases, beginning in 2012 with the electricity and industrial sectors, and expanding in 2015 to include transportation, residential, and other commercial or industrial emissions not covered in the first phase. Allowances will be auctioned and the program will enable participants to purchase a limited number of offset credits. WCI partners also envision that the cap and trade program will integrate or work in conjunction with other US or Canadian sub-national trading systems. The WCI has proved an effective forum for the dissemination of ideas throughout a large part of North America and has increased pressure on the US federal government to respond to climate challenges with a comprehensive national solution.

(d) The Midwestern Greenhouse Gas Reduction Accord

Similarly, nine Midwestern states and two Canadian provinces have formed a coalition known as the Midwestern Greenhouse Gas Reduction Accord (MGGRA) to draft a plan for GHG reductions in the largely agricultural and industrial US heartland.¹² Although MGGRA participants have held a series of meetings and prepared policy positions, the states have not yet committed to specific actions or reduction targets. According to the draft of design recommendations, released in December 2008, the MRRGA Advisory Group is considering reductions in the range of 15 to 25% below 2005 levels by 2020, and 60 to 80%

⁹ California Air Resources Board, 'Assembly Bill 32 Scoping Plan' <<http://www.arb.ca.gov/cc/scopingplan/document/scopingplandocument.htm>> accessed 2 February 2009.

¹⁰ See —, 'Western Climate Initiative' <<http://www.westernclimateinitiative.org>> accessed 2 February 2009. The participating states and provinces are Arizona, British Columbia, California, Manitoba, Montana, New Mexico, Ontario, Oregon, Quebec, Utah, and Washington. WCI observers include: the US states of Alaska, Colorado, Idaho, Kansas, Nevada, Wyoming; the Saskatchewan province of Canada; and the Baja California, Chihuahua, Coahuila, Nuevo Leon, Sonora, and Tamaulipas states of Mexico.

¹¹ Western Climate Initiative, 'Design Recommendations for the WCI Regional Cap-and-Trade Program' (23 September 2008) <<http://www.westernclimateinitiative.org/the-wci-cap-and-trade-program/design-recommendations>> accessed 15 June 2009 [hereafter: WCI Design Recommendations].

¹² See —, 'Midwestern Greenhouse Gas Reduction Accord' <<http://www.midwesternaccord.org/>>, accessed 2 February 2009. Members of the Midwestern Accord are Iowa, Illinois, Kansas, Manitoba, Michigan, Minnesota, Wisconsin. Observers include Indiana, Ohio, Ontario, and South Dakota.

below 2005 levels by 2050.¹³ The Advisory Group is also exploring the details of a cap-and-trade system for the region that will maximize the region's strengths, including its capacity for biofuels and renewable energy production and potential carbon capture and sequestration.

(e) The Chicago Climate Exchange

While not a governmental program, the Chicago Climate Exchange (CCX) has proved a useful early model for carbon trading among companies in the United States.¹⁴ CCX is essentially a demonstration project sponsored by major US GHG emitters and carbon offset project developers to field test a cap-and-trade system using a commodities trading market model. CCX covers multiple industry sectors through an agreement to reduce the six Kyoto GHGs by 6% over the period 2003 to 2010. Participation in CCX is voluntary, but once a party has joined, reduction commitments are contractually binding.¹⁵ The CCX trades its own proprietary allowances, which are allocated to emitters according to an emissions baseline, allows trading of domestic offset credits, and in theory links to the European Union Emissions Trading Scheme (EU ETS) to allow trading of ETS allowances and by indirect extension, trading of CDM credits.¹⁶

¹³ —, 'Midwestern Greenhouse Gas Reduction Accord: Preliminary Recommendations of the Advisory Group' (December 2008) <[http://www.midwesternaccord.org/Meeting%20material %20pages/GHG-meeting-8/Accord_Draft_Recs_Dec08.pdf](http://www.midwesternaccord.org/Meeting%20material%20pages/GHG-meeting-8/Accord_Draft_Recs_Dec08.pdf)>, accessed 2 February 2009.

¹⁴ See <<http://www.chicagoclimateexchange.com>>, accessed 2 February 2009.

¹⁵ Chicago Climate Exchange, 'Chicago Accord' (2004), <http://www.chicagoclimatex.com/about/pdf/ChicagoAccord_050623.pdf>, accessed 2 February 2009.

¹⁶ In practice, however, there has been little inter-continental trading as CCX credits have traded in the range of US \$2 to \$6, far below the pricing of EU ETS EUAs which have been valued as high as .30.