

Designing A Federal Carbon Regime

Friday, Jul 06, 2007 --- The United States, while a signatory to the United Nations Framework Convention on Climate Change, has not ratified and is not party to the Kyoto Protocol.

The U.S. administration has been opposed for years to any mandatory carbon regime and was committed to relying on voluntary action and a focus on technological innovation.

Today reports of major advances in addressing climate change in the United States are reported on an almost hourly basis, and even the executive position has softened somewhat.

With the advent of the 110th Congress global warming has been vigorously pursued.

Extensive hearings have been conducted to hear perspectives from scientists, economists, local governments, industry, environmentalists and other leaders.

Many bills addressing global warming were introduced in both the Senate and the House. Congress has been working hard on a variety of energy measures that, if ultimately passed by both houses, will significantly reduce green house gases.

However, Congress has put off until the fall serious negotiation on the design of a federal GHG regime.

In June 2005, the Senate passed a non-binding Sense of the Senate resolution stating that there was a growing consensus that human activity is a "substantial cause" of the accumulation of GHG and "mandatory steps" to slow or stop growth were "required."

In June of 2007 the House of Representatives passed an appropriations bill that included precisely the same language.

Thus both houses have now affirmed that "mandatory steps" are "required" and there are few in Congress who would now deny that such a federal program is desirable.

But the question is how to do it. This is a classic case of the "devil is in the details." Developing a consensus approach to this complex issue will be the subject of extensive and vigorous debate with an uncertain result.

The many difficult questions that must be addressed in developing federal GHG regulation will include:

1. Will it be a cap and trade system or a carbon tax or would just more regulation be preferable?

Under a cap and trade system, the government sets an emissions cap and emitters cover their emissions, either through an allocation by the government or through a trade/purchase.

A carbon tax would simply impose a cost on emitting a ton of carbon. Many economists and some members of industry favor a carbon tax as markedly simpler, more cost-effective and much less bureaucratic.

But most politicians balk at the word "tax" and, it is argued, a tax would not assure actually achieving a target level of emissions.

The major existing schemes for regulating GHG emissions have adopted a cap and trade market-based approach which it is argued enable goals to be met at the least cost. But there will be those who will argue that additional specific industry based regulation is the best alternative.

2. Should a cap and trade system be based on an absolute carbon cap or based on intensity which is keyed to gross domestic product?

The existing cap and trade schemes are all based on an absolute cap because while intensity may decrease, a rapidly growing economy may result in continuing increases or relatively minimal reductions in GHG emissions.

Those in favor of an intensity-based standard argue that it would cause less damage to the economy since it is keyed to move flexibly with growth. President Bush's call for voluntary action in 2002 sought cuts in GHGs based on intensity.

3. What sectors of the economy should be covered and should the same mechanism be used for all?

Consideration will be given to whether the carbon regime should be directed downstream or upstream in the distribution chain, which industry sectors should be regulated and whether some industry sectors should be phased in over time or regulated differently.

For example, difficulties in monitoring and administering in some sectors, such as biological processes, inhibit application of GHG regulation to all sectors; transportation emissions can also be dealt with through other measures such as low fuel carbon standards or more stringent Corporate Average Fuel Economy standards.

4. What should the emission reduction targets be and how should they be phased in over time?

The emission targets set by various governments vary dramatically and many set long term goals that ratchet down over time.

For example, the EU members have agreed to cut GHG emissions by 20 percent below 1990 levels by 2020, building on the Kyoto Protocol which runs through 2012, and by 30 percent if a broader international agreement can be reached.

Many states have passed legislation and/or issued executive orders calling for short term reductions in the order of 10 percent from 1990 levels by 2020 and setting long term goals of up to 80 percent by 2050.

5. Should congress establish the details of the carbon regime or should major elements be left to federal agencies?

On the one hand it can be argued that an agency is better able to develop expertise in the area and can adjust and revise regulations more expeditiously based on current developments than a legislature.

In accordance with that view, California's legislature gave the responsibility for adopting the necessary measures for achieving the state's emissions target to the California Air Resources Board and expressly allowed for the use of market mechanisms without requiring them.

However, in Congress there will undoubtedly be many who will want to be certain of the result and the timing and will have grave reservations about delegating the design of the program to any agency.

6. How should allowances be allocated if a cap and trade system is employed?

The debate here will center on whether allowances for the emission of GHG should be allocated by the government at no charge to emitters or whether they should be auctioned off, or whether some combination should be employed or phased in over time.

The EU Emissions Trading Scheme in its first phase gave virtually all allowances away for free, but a miscalculation as to the actual number of allowances required by emitters resulted in a significant over-allowance and a consequent dramatic drop in allowance values.

Under the Regional Greenhouse Gas Initiative the northeastern states party to the MOU agreed to auction off at least 25% of the allowances but several of the RGGI states are turning to a 100% auction, and so avoiding the risk of windfall profits by the electricity generators as they may pass along the value of the allowances that they have received for free to consumers and create a revenue stream for proactive measures.

7. If allowances are auctioned, how should revenues be spent?

The funds generated by allowance auctions, which may prove to be very significant, can be spent in a variety of ways related to global warming.

Most commonly discussed are expenditures on R&D, energy efficiency, financing reductions in GHGs and criteria pollutants in communities that bear a disproportionate environmental burden, retraining of displaced workers, transition assistance to firms impacted, and investments in adaptation measures to prepare for the consequences of climate change.

Which will prevail and at what levels will provide much opportunity for debate.

8. Should non-emitting energy sources be given allowances?

If allowances are allocated consideration must be given to whether they should be limited to emitters or whether non-emitting sources, like renewable energy generation facilities, should be given allowances as well.

9. Should early reductions be given credit and how should such credits be calculated and allocated?

Many companies have already taken significant steps to reduce their emissions and have captured the low hanging fruit so future reductions may actually cost them more than it would a company that has done nothing to date.

Should they get credit under the carbon regime for being an early adopter and if so how should that credit be designed? How far back should the look back be? How much credit should they be allowed? Would an auction system be sufficient to compensate them for their earlier action?

10. Should offsets be permitted and if so which offsets should qualify?

Can an emitter meet its cap by investing in projects that reduce GHG outside of its own operations, like planting trees, or investing in methane capture, or building a renewable power plant in a developing country, or should it have to find ways to reduce emissions within its own operations?

If offsets are permitted, decisions will have to be made as to which offsets should count, what percentage of emissions can be covered by offsets, whether they should be geographically limited, how they should be monitored and verified to ensure that they produce the GHG reduction for which they are being given credit, and that they are additional and permanent.

11. Should there be a safety valve if the cost of allowances rises above a specified level and, if so, how should it be set?

Many favor safety valves, which cap the price of allowances and can be

structured to permit additional sales of allowances by regulators at the capped price or provide alternative mechanisms for meeting GHG obligations.

This would ensure that severe economic dislocations will not be occasioned by high prices and would dampen sharp price fluctuations such as those that have occurred in the EU ETS.

Those opposed argue against a safety valve since if the designated price is reached, the safety valve mechanism would defeat the basic intent of the program to decrease emissions by a predetermined amount.

12. Should the federal legislation preempt the state carbon regimes being developed?

RGGI's mandatory carbon cap regime is about to commence and California is progressing in developing its program. Other states are moving into this arena as well.

It is not yet clear which states will ultimately develop their own programs or how these state programs will link. Many in industry are supporting a federal GHG program because they are seeking uniformity and certainty across the United States.

However, there is generally a reluctance to preempt states' authority and many regulations are written so as to permit the states to impose a more rigorous program than that set forth by federal law and regulation.

13. Should the U.S. regime be designed to enable trading with the international carbon regime?

Climate change is an international issue and the bigger the carbon trading market the more robust it is.

However, whether a system can be designed that would link to the existing international regimes without U.S. accession to the Kyoto Protocol, whether it would be advisable economically to link the U.S. system and how to design a compatible system that can be linked are thorny questions.

14. How can the U.S. program be designed to foster lower emissions by high emitting developing countries?

A major concern raised in connection with regulating GHG in the U.S. relates to emissions from China, now the leading emitter of GHGs, and from other developing countries.

Much attention will undoubtedly be devoted to trying to develop a program that will foster emissions reductions in these countries.

Reflecting different views on these questions, the first raft of bills introduced

ENERGY LAW 360

in the Senate in the 110th Congress vary significantly from one another and illustrate the likely debate on these issues.

The Bingaman draft bill was based on reducing carbon intensity while other bills proposed an absolute carbon cap.

The McCain–Lieberman bill capped emissions at 2004 levels starting in 2012 and increased to 60% below 1990 levels in 2050 while the Sanders–Boxer bill capped emissions at 1990 levels by 2020 and ratcheted down to achieve an 80% reduction by 2050.

The initial Feinstein–Carper bill was limited to the electricity sector while the Kerry–Snowe bill was economy wide.

The McCain–Lieberman bill established a cap and trade program while the Sanders–Boxer bill authorized the Environmental Protection Agency to establish such a program if it chooses.

The Feinstein–Carper bill specified how allowances were to be allocated and how much should be auctioned while the Kerry–Snowe bill left that to the administration.

The Bingaman draft bill included a “safety valve” in the event that allowances hit a designated price while the McCain–Lieberman bill permitted “borrowing” from future years.

The provisions for offsets and for credit for early adopters varied from bill to bill.

It has been said that a federal GHG regime will be the most ambitious and broad ranging economic regulation ever attempted in the U.S. But there is considerable momentum to move ahead and members of Congress have committed to moving this issue forward in the fall.

How Congress will ultimately respond to the lobbying efforts of the various voices of industry and of the environmental community remains to be seen. And the final question will be whether the president will sign what emerges.

--By Edna Sussman, Hoguet Newman Regal & Kenney LLP

Edna Sussman, a litigator, is of counsel to Hoguet Newman Regal & Kenney LLP in New York City. She is also the co-chair of the Renewable Energy Resources Committee of the American Bar Association and chair of the Energy Committee of the New York City Bar Association.