

## E-ALERT | Clean Energy and Climate

November 11, 2010

## CALIFORNIA CLEARS THE PATH TO A NEW CARBON MARKET

On November 2, 2010, Californians rejected a ballot initiative, known as Proposition 23,<sup>1</sup> that would have suspended the application in 2011 of California's climate change law, Assembly Bill 32, the *Global Warming Solutions Act of 2006* ("AB 32"). This now potentially clears the way for the creation, as envisioned by AB 32, of a significant new cap and trade emissions trading market in California.<sup>2</sup> The creation of a market for carbon emissions in California is particularly significant because California is the 8th largest economy in the world – larger than Russia or Spain (with a GDP of \$1.85 trillion) – and accounts for 13.04% of total U.S. GDP. Further, California produces 1.4% of total global emissions and 6.2% of total U.S. emissions. By comparison, Germany (2.69%), UK (1.84%) and Italy (1.56%) account for approximately 6% of global emissions. The importance of AB 32 is further underlined by the results of the recent U.S. federal midterm elections, which appear at this stage to have eroded support for action towards federal climate change legislation.

In 2006, the California Legislature passed AB 32, requiring that greenhouse gas emission levels in California be cut to 1990 levels by 2020 and directing the California Air Resources Board ("CARB") to develop discrete early actions to reduce greenhouse gases while also preparing a scoping plan to identify how best to reach the 2020 limit. The reduction measures to meet the 2020 target are to be adopted by the start of 2011. A key component of the policy is the implementation of a cap and trade program. On October 28, 2010, CARB released its proposed rulemaking pursuant to AB 32, the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms (the "CETP"). The CETP has been in development for four years, and its release begins a public comment period culminating in a December 16 public hearing in Sacramento, California, at which CARB will consider adopting the CETP.

The CETP is designed to work in collaboration with other complementary policies that expand energy efficiency programs, reduce vehicle emissions, and encourage innovation. The CETP provides an overall limit on the emissions from sources responsible for 85% of California's greenhouse gas emissions. The CETP requires a 15% reduction in emission levels below 2012 levels by 2020 (which would be equivalent to lowering California GHG emissions levels to the 1990 baseline or approximately 427 million metric tons CO<sub>2</sub>e). Reducing greenhouse gas emissions to 1990 levels means cutting approximately 30% from business-as-usual emissions levels projected for 2020. This equates to a reduction in emissions of approximately 2-3% per year. By contrast, the federal target under the recent U.S. House of Representatives climate bill, the *American Clean Energy and Security Act of 2009* or "Waxman-Markey" was a 7% reduction below 1990 levels by 2020 and the target

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<sup>1</sup> Proposition 23, if enacted by voters, would have frozen the provisions of AB 32 until California's unemployment rate dropped to 5.5 percent or below for four consecutive quarters.

<sup>2</sup> Note, however, that the voters did approve Proposition 26, which provides that a two-thirds supermajority vote in the California State Legislature must be achieved in order to pass certain fees, levies, charges and tax revenue – allocations that under the state's previous rules could be enacted by a simple majority vote. The costs imposed on covered entities pursuant to AB 32 and the CETP would have to be evaluated in relation to Proposition 26.

under the Senate’s climate bill, the *American Power Act of 2010* or “Lieberman-Warner” was 4% below 1990 levels by 2020.

The key components of the CERP are discussed below.

**COVERAGE - A PHASED APPROACH**

CARB has opted for a “phased approach” with respect to both implementation and coverage of Californian GHG entities under CERP. The “first phase” of CERP begins on January 1, 2012, and will initially cover approximately 360 businesses, representing 600 of the state’s largest GHG-emitting sources (primarily industrial sources and electricity generators), along with electricity imports. The “second phase” begins in 2015, when the program expands to include suppliers of transportation fuels and industrial fuels not otherwise covered in the first phase that emit in excess of 25,000 metric tons of CO<sub>2</sub> (specifically, suppliers of natural gas, suppliers of RBOB<sup>3</sup> and distillate fuel oils, and suppliers of LPG). This approach mirrors the approach adopted by the Western Climate Initiative (“WCI”) which also has two phases covering similar entities.<sup>4</sup>

The CERP provides for three-year compliance periods commencing on January 1, 2012 and concluding on December 31, 2020. The California GHG Allowance Budgets are as follows:

	Budget Year	Annual Allowance Budget (Million of CA GHG Allowances)
First Compliance Period	2012	165.8
	2013	162.8
	2014	159.8
Second Compliance Period	2015	394.5 <sup>5</sup>
	2016	382.4
	2017	370.4
Third Compliance Period	2018	358.3
	2019	346.3
	2020	334.2

Further, an entity that does not meet the emission threshold (25,000 metric tons of CO<sub>2</sub>e) may elect to voluntarily “opt-in” to the program (with corresponding compliance and reporting obligations) and may “opt-out” of the program at the conclusion of any compliance period provided its emissions are below the threshold level. The CERP also specifies certain exempt fuel classes which, though required to be reported, do not count towards an entities compliance obligation. These exempted categories include emissions from biomass-derived fuels, agricultural crops or waste, biodiesel, fuel ethanol, biomethane and municipal solid-waste.

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<sup>3</sup> Reformulated Gasoline Blendstock for Oxygenate Blending.

<sup>4</sup> The WCI is a collaboration of independent jurisdictions in the United States and Canada who commit to work together to identify, evaluate, and implement policies to tackle climate change at a regional level (Arizona, Oregon, California, Washington, Utah, New Mexico, Montana, British Columbia, Quebec, Manitoba, Ontario). For more information on the WCI, see [here](#).

<sup>5</sup> The allowance budget increases sharply at the beginning of the second compliance period because of the new covered sectors (fuels) and the inclusion of these additional emissions under the cap.

## ALLOCATIONS

The CETP has adopted a similar approach to allocations as that initially taken under the European Union Emissions Trading Scheme (“EU ETS”) which distributed 100% of emission allowances to entities for free in the first phase and then transitioned to an auction basis (CETP will distribute a majority of its allowances with the remainder to be auctioned – see below). CARB will issue approximately 2.7 billion allowances from 2012 to 2020. Allocations to covered entities will be based upon roughly 90% of the most recent historical emissions levels, graduating over time to an auction process. This approach is based upon a policy of risk aversion: the fear of a shortage in allowances leading to price spikes in the early years and an economic concern that the introduction of a trading scheme would depress economic activity, particularly in California’s challenged economy. Earlier versions of the system contemplated auctioning a substantial portion of the allowances from the outset.

## COST CONTROL MECHANISMS AND OFFSETS

One of the key issues for the CETP given the current state of the Californian economy is an emphasis on effective cost control. CETP contemplates three distinct mechanisms to address cost containment: (1) quarterly auctions of allowances; (2) a cost containment reserve; and (3) offsets. CETP provides for an initial funding of the allowance auction pool of approximately 43.7 million allowances for advance auction (or 2% from budget years 2015-2020), with the remainder of allowances not otherwise distributed in each budget year to be auctioned also. The initial reserve price (which would operate as a de facto floor price) for the advance auction of allowances in 2012 will be \$10 (increasing annually to 2014 by 5% plus CPI) and thereafter \$11.58 for subsequent auctions (increasing annually to 2020 by 5% plus CPI). CARB will also transfer a specified percentage of all allowances in each three-year phase between 2012 and 2020 into an Allowance Price Containment Reserve, totaling 123.5 million allowances, which will be made available to covered entities at set prices on a quarterly basis from March 4, 2012.

A key feature of the tools identified above to assist cost control under the CETP is the limited use of offsets. CARB includes offsets in the CETP design to reduce compliance costs by introducing a broader range of cost effective emissions reduction opportunities. The CETP will allow the use of offsets for up to 8% of a facility’s compliance obligation (up from 4% which was initially proposed) in order to provide flexibility for entities in meeting their compliance obligations. As offsets potentially represent 8% of the total allowance market, the potential monetary value of the offset market under CETP (absent linkages) ranges from between \$315 million and \$630 million.<sup>6</sup> This is a much smaller potential (eligible) “pot” of offsets than was allowed in either Waxman-Markey or various proposed U.S. Senate bills, where offsets could have covered 30% or more of emission reductions and thus were projected to have a dramatic impact in reducing estimated costs of compliance compared to having no offsets.

Moreover, the effectiveness of offsets for cost containment depends in part on the availability of such offsets to compliance entities. CARB permits a very limited category of projects to be eligible for offset accreditation at the beginning of the program, raising the issue of whether offsets will in fact operate to provide cost reductions. Four initial offset protocols are eligible under the offset program: forestry; urban forestry; livestock (manure/methane) management; and, removing ozone-depleting substances. Currently, forest projects registered with the Climate Action Reserve have absorbed 1,735,436 metric tons of CO<sub>2</sub>e from the atmosphere.<sup>7</sup> This represents between 1% and

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<sup>6</sup> Assuming an offset price of between \$10 and \$20 based upon the 2012 and 2015 allowance market size.

<sup>7</sup> See [here](#).

less than half of 1% (0.4%) of the total allowance allocation over the first two phases of the program. Further, offset project developers have indicated that it takes at least several years to bring projects to fruition and reduce emissions. Under other cap and trade schemes, such as the EU ETS, covered sources have attempted to maximize their use of offsets in early periods in order to create and bank excess allowances for use in later periods. There is a risk of a lag between the offset limit and a corresponding increase in offset supply.

## SECTORAL CREDITS AND REDD

The CERP also makes provision for the inclusion and use of sectoral offset credits from developing countries and from “subnational jurisdictions” within developing countries for use as compliance instruments. The purpose of inclusion of sectoral credits is to prevent leakage within a particular uncapped sector and to increase the environmental integrity of the system by ensuring real and verifiable reductions across entire sectors of the economy. CERP makes special reference to the use of reduced emission from deforestation and forest degradation (“REDD”) plans. However, several steps will need to be taken before California could accept sectoral credits for compliance purposes (particularly with respect to sectoral credits from international REDD) including: appropriate sector-wide readiness (monitoring, reporting and enforcement), and sectoral accounting (national or subnational baselines).

California, along with 14 states in Brazil, Indonesia, Nigeria, and Mexico,<sup>8</sup> has established the Governors’ Climate and Forest Taskforce (“GCF”), which is designed to integrate REDD and other forest carbon activities into emerging GHG compliance regimes in the California, other states of the United States and elsewhere. The GCF has established working groups focused on developing standards and criteria for compliance-grade REDD activities at the project or site-specific level and on a “nested” basis within subnational (state or province-wide) schemes. While CERP does not yet provide for the inclusion of REDD offsets from GCF states, the inclusion of a sub-national sectoral REDD mechanism for REDD offsets suggests that these offsets will likely be eligible in the future.

## LINKING, RECOGNITION OF OTHER COMPLIANCE INSTRUMENTS AND FEDERAL CAP AND TRADE

The program design also provides for compliance instruments from other recognized programs to be used for compliance in the same manner as offsets. The WCI, EU ETS and RGGI programs have been discussed as potential candidates for linking. A unilateral link that makes instruments in those programs eligible for compliance in CERP could enhance the supply of instruments. If a unilateral link is established, covered sources in the California program will decide whether to purchase instruments from other programs and use them for compliance. The price of those instruments relative to the price of offsets and emission allowances issued under CERP will likely be an important factor affecting the extent to which the instruments from other programs are introduced. Interestingly, an “allowance” approved for use within the CERP with respect to an external GHG ETS is not subject to the 8% offset limitation, however, an offset or sector-based credit is subject to such quantitative limits (see section 95942(b), (c)).

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<sup>8</sup> The GCF states and provinces are Aceh (Indonesia); Acre (Brazil); Amapá (Brazil); Amazonas (Brazil); California (U.S.); Campeche (Mexico); Cross River State (Nigeria); East Kalimantan (Indonesia); Illinois (U.S.); Mato Grosso (Brazil); Papua (Indonesia); Pará (Brazil); West Kalimantan (Indonesia); and Wisconsin (U.S.). Chiapas (Mexico) has recently been admitted into the GCF and other Mexican states are considering the possibility of participation. The 2010 Chairs of the GCF are Amazonas and Pará.

## FRAUD PROVISIONS

CARB has drafted the CETP based upon a serious concern for problems experienced with market fraud in other emissions markets. Two notable features of the CETP address specific concerns in the emissions markets being: (1) the imposition of emissions compliance penalties for a failure to surrender allowances equal to the compliance obligations of a particular entity, and (2) rigorous enforcement of offset issuance standards to address fraud in the creation and continuing validity of offset instruments. Covered facilities must surrender allowances/offsets equal to 30% of the previous year's emissions on an annual basis. CETP imposes a stringent allowance penalty per ton for a particular compliance period, requiring the entity to surrender four times the missing allowances, and prohibiting the use of offsets to satisfy a non-compliance surrender obligation. This is in contrast to the EU ETS which imposes a fixed monetary penalty for non compliance which operates as a default ceiling price for the value of emissions allowances under the scheme.

One of the most important compliance issues related to offsets is determining who should bear the risk that an offset will fail to achieve its expected emissions goals. The CETP addresses this issue in two ways, firstly by requiring rigorous third party verification of emissions reductions or GHG removals by a CAR-accredited verification body for the purpose of verifying offset project data reports and, in the case of forest offset sequestration projects, by placing a percentage of issued offsets in a "buffer account" for any reversals of failed forest offset projects. Further, CETP provides that for forest sequestration projects, if CARB determines that there has been an "intentional reversal" in the amount of carbon sequestered pursuant to the forest offset project, CARB will terminate the project. If such a determination is made, new offset projects are prohibited from being initiated within the same offset project boundary as the terminated project and any offset credits issued to such a project may be determined to be invalid. The covered entity that retired the offset credit for purposes of demonstrating its own compliance with the requirements of AB32 would then be forced to find a replacement for the invalidated credits. This provision is likely to have a severe impact upon the market in forest offsets based upon the reversal risks associated with such activities, which would attach to credits issued or sold to both project developers and potential buyers of such credits.

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