# Update on Potential Legal Issues Related to the California Cap-and-Trade Program

CLIMATE ACTION RESERVE

March 14, 2012
10:00 AM PST

# Agenda

- Overview and Introduction
  - Katharine Young, General Counsel, Climate Action Reserve
- Special Guest Speakers:
  - JP Brisson, Senior Counsel at Linklaters, LLP
    - Potential Commerce Clause Challenges
  - Tom McHenry, Partner at Gibson, Dunn & Crutcher
    - Potential Proposition 26 Challenges
- Open Discussion of Remaining Legal Issues Related to the Launch of California's Cap-and-Trade
- Questions and Answers

# California Cap-and-Trade: Background & Overview

CLIMATE ACTION RESERVE

- AB 32: *Global Warming Solutions Act* (2006)
  - Goal: to reduce statewide GHGs to 1990 levels by 2020
  - Scoping Plan (2008): Outlines Overall Strategy to Meet AB 32 Reduction Requirements
    - Pavley Vehicle Standards, LCFS, RPS, EE, Direct Regulation, and Cap-and-Trade)
- ARB Adopted Cap-and-Trade Regulation, Oct. 2011
  - Three compliance periods: 2013-2014, 2015-2017, 2018-2020
  - Declining Cap on GHGs, allows regulated entities to meet lower emissions through combination allowances and offsets
  - Offsets can be used to satisfy 8% of compliance obligation

# Offsets in California Cap-and-Trade

- Four Climate Action Reserve project protocols have been adopted by ARB
  - Livestock, Forestry/Urban Forestry, Ozone-Depleting Substances (ODS)
  - Other protocols under consideration
- The Reserve will seek accreditation from ARB to serve as an official Offset Project Registry (OPR)
- Early-Action Offsets
  - Projects under four approved protocols of vintages 2005-2014, listed by February 2015
  - Must go through desk verification using ARB accredited verifier

# California Cap-and-Trade: Remaining Issues & Key Dates

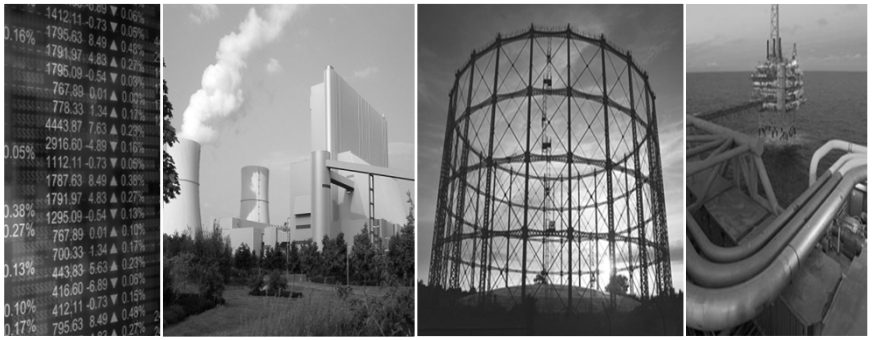
CLIMATE ACTION RESERVE

- Spring/Summer 2012
  - Draft Linkage Agreement with Quebec
  - WCI List of Priority Protocols Released
  - Training and Accreditation of Verifiers and Registries
  - Guidance on Early Action Credit Conversion and Offset Registration Process
- Summer 2012
  - Expected ARB Hearing to consider final adjustments to cap-and-trade regulation and Quebec linkage agreement
- Summer/Fall 2012:
  - August 15, 2012: 1st Allowance Auction & November 14, 2012: 2nd Auction
  - Possible ARB Board consideration of additional offset protocols

# Implications of LCFS Decision for Cap-and-Trade

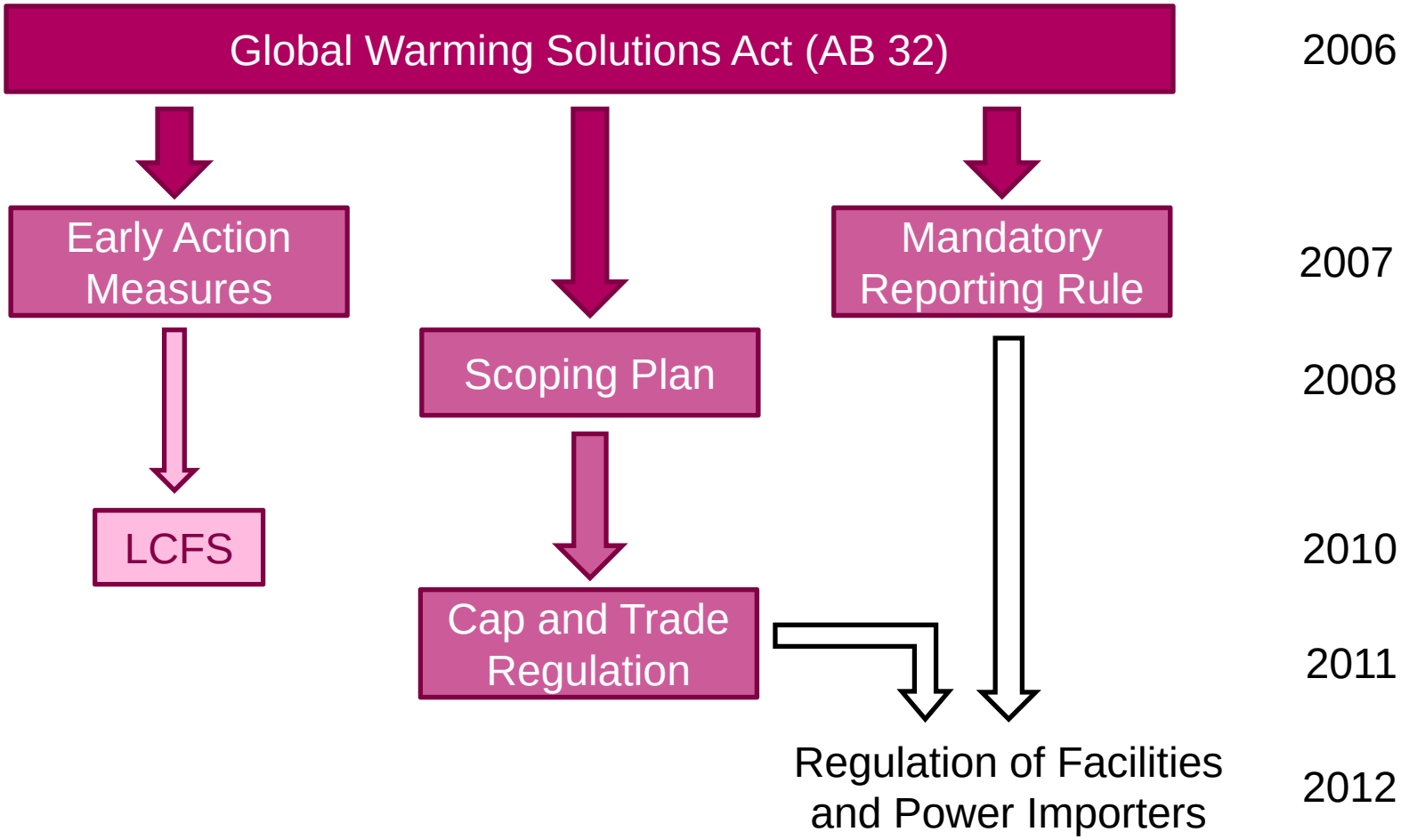
Climate Action Reserve Webinar
March 14, 2012

Jean-Philippe Brisson
jp.brisson@linklaters.com



Linklaters

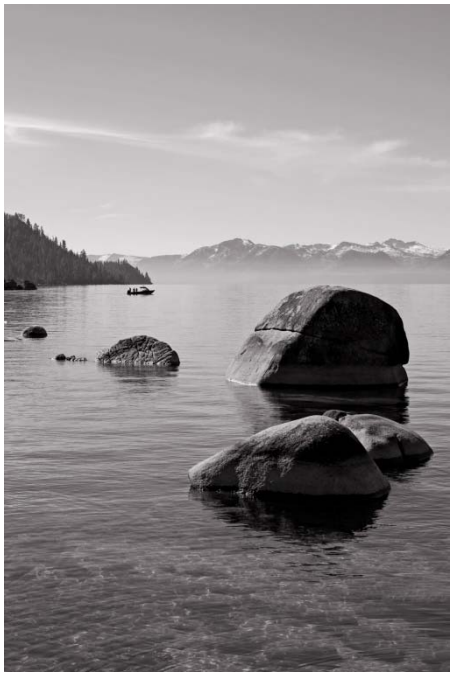
# Background


Global Warming Solutions Act (AB 32)
2006
Early Action Measures
Scoping Plan
Mandatory Reporting Rule
2007
2008
LCFS
2010
Cap and Trade Regulation
2011
Regulation of Facilities and Power Importers
2012

# LCFS Summary

- Goal – reduce “carbon intensity” of all transportation fuels consumed in California by 10% by the year 2020
- Scope – all transportation fuels, including gasoline, diesel, natural gas, ethanol and electricity, “sold, supplied or offered for sale in California”
- Carbon Intensity – a numerical value (CI) assigned to each fuel “pathway,” measured in grams of CO2-equivalent per megajoule, that encompasses all GHG emissions associated with the fuel’s production, refining, transportation and combustion
- Life Cycle Analysis – uses a model developed by Argonne Nat’l Lab and adapted by California to estimate direct and indirect emissions associated with fuel pathways, including “indirect land use change”
- Credits – if fuel sold or imported into California has a higher CI than the state average, seller/importer must buy and surrender credits; if CI is lower than the average, credits are generated and can be sold for profit

# LCFS Carbon Intensity Lookup Table



**Carbon Intensities Assigned to Midwest and California Corn Ethanol**

| Fuel | Fuel Pathway | Assigned Total Carbon Intensity (gCO2e/MJ) | Difference Between Carbon Intensities for Midwest and California Corn Ethanol (gCO2e/MJ) |
|---|---|---|---|
| Corn Ethanol | 1. Midwest; Dry Mill; Dry DGS; NG | 98.40 | 9.50 |
| | 1a. California; Dry Mill; Dry DGS; NG | 88.90 | -- |
| | 2. Midwest; Dry Mill; Wet DGS; NG | 90.10 | 9.40 |
| | 2a. California; Dry Mill; Wet DGS; NG | 80.70 | -- |
| | 3. Midwest; Dry Mill; Wet DGS; 80% NG; 20% Biomass | 86.80 | 9.36 |
| | 3a. California; Dry Mill; Wet DGS; 80% NG; 20% Biomass | 77.44 | -- |

Source: *Rocky Mountain Farmers Union v. Goldstene*, 09-CV-02234 (Dec. 29, 2011), p.14

# Commerce Clause Standards of Review

- Strict Scrutiny (tends to favor industry): a state law controls commerce occurring wholly outside the state's borders, or discriminates against out-of-state interests
  - on its face;
  - in its purpose; OR
  - in practical effect
- *Pike* Balancing Test (tends to favor state): non-discriminatory state laws will only be struck down if burdens on interstate commerce outweigh their benefits

# Rocky Mountain Case Summary

- Decisions issued December 29, 2011
- Holding
  - A Clean Air Act exemption for California does not shield ARB from Commerce Clause challenges to the LCFS
  - LCFS is unconstitutional: facially discriminates against interstate commerce and impermissibly controls out-of-state conduct
  - Court reserved judgment on plaintiffs' federal preemption claim

# Next Steps

- ARB is appealing Rocky Mountain to the 9th Circuit
- Will the District Court's decision be stayed pending the appeal?
  - District Court denied the stay
  - ARB requested stay from Court of Appeals
- Will ARB prevail on the substance?
  - Timing
  - Next step is US Supreme Court

# Power Imports under Cap-and-Trade

- Generators based in California have the compliance obligation
- All electricity imports into California are subject to the cap
  - Compliance obligation falls on “First Jurisdictional Deliverer”
    - Determined by Purchasing-Selling Entity (PSE) on NERC E-tag between Balancing Authority Areas (BAAs)
- How are the emissions calculated?
  - Unspecified sources are assigned a default emission rate (initially set at 0.428 MT/MW)
    - Examples: coal is approx. 1 MT /MW; gas is approx. 0.45 MT/MW
  - Importer can claim facility specific emissions rate lower than default rate under certain circumstances
- Prohibition on “Resource Shuffling” to receive credit for emissions reductions that have not occurred

# Considerations for Potential Challenges

- What test applies?
  - First jurisdictional deliver?
  - Resource shuffling?
  - Other provisions? Industry assistance factor?
- Other claims based on federal preemption or California state law
- No lawsuits has been filed yet

# Notice

This presentation is for informational purposes only and does not constitute or provide legal advice or create an attorney-client relationship.

Linklaters in the U.S. provides leading global financial organizations and corporations with legal advice on a wide range of domestic and cross-border deals and cases. Our offices are located at 1345 Avenue of the Americas, New York, New York 10105.

Linklaters LLP is a multinational limited liability partnership registered in England and Wales with registered number OC326345. It is a law firm authorised and regulated by the Solicitors Regulation Authority. The term partner in relation to Linklaters LLP is used to refer to a member of Linklaters LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP and of the non-members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ, England or on www.linklaters.com.

Please refer to www.linklaters.com/regulation for important information on our regulatory position.

# AB 32 CAP-AND-TRADE LITIGATION UPDATE

# MARCH 12, 2012

Thomas J.P. McHenry
333 South Grand Avenue
Los Angeles, California 90071
TMcHenry@gibsondunn.com
(213) 229-7135

GIBSON DUNN

## *Association of Irritated Residents v. California Air Resources Board (AIR v. ARB)*, Case No. A132165, First Appellate District, app. pending

- Plaintiffs are environmental justice advocates: CBE and CRPE
- Concerned that C&T will have negative health and environmental impacts on disadvantaged communities
- Plaintiffs challenged numerous regulatory provisions of the cap-and-trade program
- Also challenged under CEQA for failure to adequately analyze alternatives March 18, 2011 decision finding inadequate alternatives analysis
- Appeal pending before the First Appellate District (San Francisco)
- Appellate briefing completed February 2012 -- request for oral argument pending

# What *AIR v. ARB* Court Did *Not* Do in March 2011

- Did NOT allow a challenge to the "Fundamental Legitimacy" of ARB's scoping plan for AB 32
- Did NOT prohibit use of a statewide emissions limit as a target
- Did NOT prevent use of the "Cost of a Bundle of Strategies" approach to determine cost-effectiveness
- Did NOT disallow exclusion of agricultural sector
- Did NOT invalidate regulation of the industrial sector through C&T

# Lessons Learned from *AIR v. ARB*

- Easier to sue under CEQA than make a facial challenge under AB 32
- Overall ARB regulatory program upheld in first court challenge
- ARB has moved C&T program ahead
- Differing viewpoints:
  - "ARB is clueless and uninterested in doing anything other than full-steam ahead and seems to think Arnold is still governor."
  - "The sun will come up tomorrow. There will be a cap-and-trade program. We will be trading in 2010."

# Potential Litigation on Cap & Trade

- No lawsuits filed challenging Cap & Trade program since the final regulations were released in October 2011.
- Threats of litigation -- Email from Eric Eisenhammer, founder of the Coalition of Energy Users, posted on October 31, 2011 stated that "Warren and Pam Duffy's Southern California chapter of the Committee for a Constructive Tomorrow (CFACT SoCal) has found a legal team who seeks injured parties as potential Plaintiffs in an Anti Cap and Trade-AB32/CARB lawsuit. CFACT will set up teleconference interviews with the attorneys to determine qualifying criteria."
- Timing
- Laches

# Potential Proposition 26 Challenge to AB 32

- Prop 26: "Any change in state statute which results in any taxpayer paying a higher tax must be imposed by an act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature." 11/2/10
- Changed definition of "tax" for local governments to include fees -- applies to any tax adopted after January 1, 2010.
- CARB will hold auctions -- may be classified as a tax under Prop 26.
- Jon Coupal of the Howard Jarvis Taxpayers Association: "There is a very strong possibility of litigation over Cap & Trade under the new constitutional rules set forth in Prop. 26." ( Email from to Robert Collier, as reported by Collier on his website: www.climatespeak.com/2011/10/california-cap-and-trade)

## *Schmeer v. Los Angeles County*, Super. Ct. Los Angeles County, Filed Oct. 02, 2011, Case No. BC-470705

- Challenge to Los Angeles County's 10-cent charge for paper bags as an unconstitutional "tax" under Proposition 26.
- 10-cent charge is retained by the retailer (although with restrictions on its use tied to the costs of the bags and educational materials or campaigns for reusable bags), and may therefore not be considered "imposed by a local government."
- Charge may fit under the exception of a "charge imposed for a specific government . . . product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of providing the . . . product."
- Los Angeles Superior Court hearing scheduled tomorrow -- March 15.
- Defense is that County not receiving the money.
- "Too big an issue not to go up on appeal"

## *Independent Energy Producers v. County of Riverside*, Super. Ct. Riverside County, Filed Feb. 03, 2012, Case No. INC 1200838

- Filed in February 2012
- Challenge to Riverside County solar "tax"
- County approved an annual $450 per acre charge in November 2011 to mitigate the impact of a solar power installation.
- The County argues that the fee is to compensate them for the impact of the solar project and the County is sacrificing land that would otherwise be used for agriculture, development, or open space preservation.
- Independent Energy Producers argue that the fee violates Proposition 26 because it has no relationship with the impacts to the County or on the services provided by the County.

# Possible Defenses to Prop 26 Challenge to Cap & Trade

- Prop 26 only addresses state statutes and local governments – does not mention state administrative regulations.
- AB 32 passed in 2006, long before Proposition 26 -- Prop 26 may not apply because there is not a "change in state statute" imposing a new tax after January 1, 2010.
- If additional legislation needed to modify the cap and trade system, will need to follow Proposition 26.
- Cap and trade could generate billions of $ of new revenue annually that could be used for budget problems. http://latimesblogs.latimes.com/california-politics/2012/02/california-cap-and-trade.html

# NAFTA and Sovereign Entity Challenges

- September 27, 2011 letter to ARB from Powerex, subsidiary of BC Hydro, stating that ARB NAFTA prohibits any measure affecting the transmission of energy
- AB 32 regulations would unlawfully favor American power supplier Bonneville Power Administration (BPA) because they give special status to BPA that exempts it from reporting on greenhouse gas emissions.
- CARB exempted BPA because owned by the US government and not subject to state regulation (markets power generated at federally owned dams).
- BC Hydro's claim is that Powerex is entitled to parity treatment with BPA because BC Hydro is government-owned as well.
- BPA also claims that CARB cannot regulate its power transactions because it is a sovereign entity under federal law.

# Thomas McHenry

Tom is a partner in Gibson Dunn's Los Angeles office and a member of the firm's Environment and Natural Resources practice. He practices general environmental law with an emphasis on air quality, hazardous waste, environmental diligence, land use and energy issues.

Tom has broad experience with air quality compliance and permitting. He has advised companies on new source review, emission reduction credits and rulemaking issues and has handled enforcement and compliance issues before all the major air districts in California and the California Air Resources Board.

Contact:

333 South Grand Avenue

Los Angeles, CA 90071-3197

Tel: 213.229.7135

tmchenry@gibsondunn.com

CLIMATE ACTION RESERVE

# Questions?

# Upcoming Events

CLIMATE ACTION RESERVE

## Workshops:

- BC3 Offsets Workshop, San Francisco, March 15th
- Got Manure Carbon Management Workshop
  - Syracuse, NY – March 27th
- Reserve 101 – CA Compliance Workshop
  - San Francisco, CA - April 10th

## Annual Conference:

*Navigating the American Carbon World 2012*

- April 10-12 2012, San Francisco, CA
- www.NACW2012.com

# Contact Information

policy@climateactionreserve.org

www.climateactionreserve.org

**523 W. 6th Street, Ste. 428**

**Los Angeles, CA 90014**

**213-891-1444**