



SHAPING FEDERAL CLIMATE CHANGE LEGISLATION: **A HOT TOPIC**

Throughout his campaign, Barack Obama expressed his commitment to combating climate change. In his inaugural address, he again discussed working to “roll back the specter of a warming planet.”¹ With the new federal administration and Congress, there remains little doubt that federal climate change legislation is on the horizon. However, the extent and parameters of such legislation are very much an open question. This article identifies and discusses some of the fundamental issues that will need to be resolved in any federal climate change legislation.

As an initial matter, some have questioned whether the current economy makes near-term federal climate change legislation unlikely. In these difficult economic times, the impact of climate change legislation on job growth and development will be hotly debated. Yet while the costs of reducing greenhouse gas emissions can be seen as a drag on economic growth, economic policies and climate change policies are not necessarily in conflict.

First, the compliance date in any federal legislation can be set to some point in the future in order to permit businesses time to prepare to meet their new obligations. A new international climate change treaty is currently being negotiated to take effect in 2012, which could be a target date for federal regulations to take full effect.

Second, industry itself is pushing for federal climate change legislation in order to avoid a patchwork of conflicting local programs or regulation under the Clean Air Act, both of which are seen as undesirable.² Federal climate change legislation, on the other hand, will provide industry with certainty.

Additionally, a cap-and-trade program, as discussed below, has the potential for injecting significant money into the Treasury that could be used for investments in clean energy technologies and the creation of new jobs. At the same time, the implementation of energy efficiency projects and the construction of renewable energy facilities can be drivers for the creation of a new, green economy. While addressing the



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economy is currently the No. 1 priority, there is no indication that it will supplant efforts for greenhouse gas regulation.

CHOOSING A REGULATORY APPROACH

At least three different approaches have been suggested to regulate greenhouse gas (“GHG”) emissions: (1) cap-and-trade; (2) carbon tax; and (3) command-and-control. Under a cap-and-trade approach, an overall cap on carbon emissions would be established and companies would be required to possess tradable allowances to emit greenhouse gases. Cap-and-trade is the regulatory approach favored by the Obama administration and has been the approach of most of the significant federal climate change legislative proposals to date, including the Waxman-Markey American Clean Energy and Security Act, which the House Energy and Commerce Committee approved in May.

As an alternative to cap-and-trade, some experts have suggested imposing a carbon tax, which would set a fixed price per ton of GHG emissions, thereby providing a financial incentive for companies to reduce their emissions. Proponents argue that a tax would be easier to implement and would have fewer transactional costs than a cap-and-trade system. Furthermore, economic costs are easier to quantify for a carbon tax than for a cap-and-trade system, since the price of emissions would be set and not subject to market fluctuations. However, opponents argue that a tax would not provide a guaranteed level of emission reduction and would place an unfair burden on the consumers who are least able to afford the resulting increased energy and gas prices. While some companies may prefer a carbon tax because they would be better able to plan for its costs and have more flexibility, garnering political support for a substantial new tax would likely be difficult.

Rather than choosing these market-based approaches, the federal government could instead elect to reduce GHG emissions through a more traditional “command and control”

program, under which limits on GHG emissions would be imposed on facilities through air permits, with penalties for exceeding such limits. This could be accomplished through new legislation or amendments to the Clean Air Act, or potentially by using the existing Clean Air Act (an alternative that is explored further in this issue of *Practice Perspectives*; see “A Word of Caution: Can Greenhouse Gases Be Regulated Effectively Under Existing Law?”). Economic theory suggests that a command-and-control approach would be the least efficient means of accomplishing a reduction in GHG emissions because it mandates specific emission reductions without regard to cost.

DRAFTING A CAP-AND-TRADE PROGRAM

Because some variation of a cap-and-trade program appears to be a likely component of any federal climate change legislation, this section explores some of the key issues that must be resolved in developing such a program. First, since a cap-and-trade system is premised on a target future emission cap, that overall target must be established. Consensus is building among the administration, Congress, and industry groups for an 80 percent reduction by 2050.³ However, there is less agreement regarding the number and types of sources that would be subject to regulation, how allowances would be distributed, treatment of offsets, and the effect of federal regulation on state and regional programs.

Whom to Regulate? A decision must be made between an economy-wide program that would address GHG emissions from a variety of sources versus a more targeted program that would be limited to some subgroup of larger emitters. Here, legislators must strike a balance between the fairness and usefulness of regulating only certain sectors that represent only a percentage of total emissions and the administrative burden of regulating all sources down to each individual vehicle. One possible solution is a “phase-in” approach, whereby certain economic sectors that have more experience in implementing GHG emission controls, such as the

Congress, percent reduction by 2050.



electric utility industry, would be regulated first, with other sources being added over time. Another possible solution is to establish a threshold emission amount and exempt from regulation emissions below the threshold.

In addition to identifying the sources that will be regulated, the point of regulation must be determined. Will emission limits apply “upstream,” at the point fossil fuels are extracted, or “downstream,” at the point that greenhouse gases are actually emitted into the environment? In an “upstream” system, a coal company would need to possess an allowance for every ton of carbon contained in the coal it extracts from the earth, while in a “downstream” system, the allowance would be required of the party burning that coal, such as an electric power plant. The benefit of “upstream” regulation is that it limits the number of regulated entities. For example, only a relatively small number of oil and gas companies would be required to possess allowances, as opposed to requiring each individual who drives a car or fires a natural gas furnace to have a carbon allowance for those emissions. The benefit of “downstream” regulation is that it places the regulatory burden on the parties most able to reduce emissions: the end users. Most likely, a workable economy-wide cap-and-trade system will require some combination of upstream and downstream regulation. For example, the point of emissions may be the compliance point for stationary-source emissions, while the regulations would apply to fuel distributors for mobile-source emissions.

Distribution of Allowances. Another fundamental issue is how to distribute emission allowances. A cap-and-trade system works by providing a certain number of emission allowances at the outset of the program and then ratcheting down the total number of allowances in the market over time in order to meet the ultimate emission targets. These initial allowances can be either allocated among affected sources, purchased through an auction process, or distributed through some hybrid of allocation and auction. An auction process would

generate significant revenue, which could be used to fund clean energy technologies, provide energy assistance for low-income persons, or fund GHG-related research. However, opponents of an auction system raise concerns about fairness (e.g., deep-pocket buyers may have an advantage over small businesses), hoarding (e.g., large companies or hedge funds may purchase large blocks of allowances, leaving a shortage for smaller emitters), international competitiveness (e.g., the costs of purchasing allowances would be passed on to customers, disadvantaging domestic industries with strong foreign competition, such as the steel and paper industries), and market volatility.

One way to address volatility and cost concerns in an auction system is to provide a “safety valve” if allowance prices exceed a certain threshold level. If the cost to purchase an emission allowance exceeded that predetermined level, the government would make additional allowances available at the threshold price in order to flatten the market and control costs. Of course, this is easy in concept but potentially challenging to administer. Setting an appropriate maximum threshold price may be difficult prior to the development of the market. In addition, there would need to be some method for adjusting the threshold price over time and in reaction to the market. If the threshold price is set too high, it will not achieve the goal of controlling market volatility and economic impact. On the other hand, if the threshold price is set too low, it will allow excess allowances into the market, making it difficult, if not impossible, to meet the emission targets. Some have proposed placing authority either in an existing agency, such as EPA, or in a newly created carbon market control agency, to set threshold prices and make other adjustments to the market as needed.

Offsets. Another issue is whether, and to what extent, to allow the use of offsets. An offset represents a GHG emission reduction generated by emission-reducing projects



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renewable energies, or installation

outside the regulatory system. For example, an offset may represent GHG emission savings achieved through reforestation projects, investments in renewable energies, or installation of emission-control technologies on factories in third-world countries. Offsets allow a company the flexibility to achieve some or all of its required emission reductions at a lower marginal cost by funding less expensive projects that provide an equivalent net emission reduction. Numerous studies have found that allowing the use of carbon offsets can significantly decrease the compliance costs necessary to achieve emission reductions. U.S. Government Accountability Office, “Carbon Offsets: The U.S. Voluntary Market Is Growing, but Quality Assurance Poses Challenges for Market Participants,” GAO-08-1048, at 33 (August 2008). Offsets also stimulate investment in new technologies and encourage emission reductions from nonregulated sources.

Despite these benefits, many have raised concerns about the credibility of offsets and the potential for overuse or improper use of offsets to negate the overall effectiveness of legislation to meet emission targets. More than 600 entities develop, market, or sell offsets in the United States. *Id.* at 7. Any federal climate change legislation incorporating the use of carbon offsets must include standardized quality assurance mechanisms to ensure the integrity of the market and the credibility of the offsets. *Id.* at 38. Credible offsets must be additional (*i.e.*, the reductions must be above what would have otherwise occurred), quantifiable, verifiable, and permanent.

In addition to resolving concerns about the credibility of offsets, lawmakers will need to decide the extent to which offsets may be used to meet regulatory requirements. Both the percentage of emission reductions that may be achieved through offsets and the geographic distribution (domestic versus international) of permissible offset projects will need to be determined. This will involve a balancing act between cost and effectiveness—increased use of offsets will result in

lower compliance costs but could also make it more difficult to meet national emission reduction commitments.

Leakage and Economic Impact. Any GHG regulatory structure must address the issue of leakage (or the increase of GHG-emitting activity in jurisdictions outside the United States as a result of stricter domestic GHG regulations). Energy-intensive industries such as cement and metals could have a competitive disadvantage if U.S. operations have GHG compliance costs that similar operations in other countries do not. Increased domestic compliance costs could also cause U.S. operations to move abroad to locations without similar climate policies. To prevent this, import fees could be imposed to compensate for cost differences or free allowances, or subsidies could be provided to industries at high risk for carbon leakage.

Interplay With Other Federal, State, and Regional Programs. In the absence of federal regulation of greenhouse gases, several state and regional cap-and-trade programs have emerged, including the Regional Greenhouse Gas Initiative (in the northeastern and mid-Atlantic states), the Western Climate Initiative, the Midwestern Greenhouse Gas Reduction Accord, the California Global Warming Solutions Act of 2006, and the Florida Climate Protection Act of 2008. These local programs provide models for federal legislation and have served as a testing ground for some of the issues discussed above. Any federal climate change legislation will need to evaluate whether the federal program can exist alongside these programs or will preempt local regulations. While some state or regional programs may be redundant of federal regulations, others may impose stricter emission reduction targets, and Congress will need to decide whether states may exceed the federal limits.

Comprehensive federal climate change legislation will also raise questions about other federal, state, and local regu-

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lations aimed at curbing greenhouse gases. For example, approximately half of the states have implemented some type of Renewable Portfolio Standard, which establishes target dates by which a certain percentage of the electricity generated in that state must come from renewable sources, such as wind, solar, or geothermal. President Obama also favors a federal Renewable Portfolio Standard, requiring 25 percent of electricity to come from renewable sources by 2025.⁴ These goals are supported by the federal Production Tax Credit, which provides income tax credit for renewable energy production. Experts disagree about the place of Renewable Portfolio Standards and the Production Tax Credit in a market-based cap-and-trade program. Some argue that the amount of investment in renewable sources should be determined by the market and that Renewable Portfolio Standards place too much emphasis on investment in developing renewable energy at the expense of investment in carbon sequestration technologies. Others argue that incentives for renewable energies are necessary, at least in the early years of a cap-and-trade system, in order to stimulate the market until the market corrects itself under the cap-and-trade program.

The interplay between federal climate change legislation and vehicle and fuel standards meant to limit GHG emissions from the transportation sector will also need to be addressed. Currently, these mobile-source emissions are primarily regulated through federal Corporate Average Fuel Economy (“CAFE”) standards, aimed at improving the average fuel economy of vehicles sold in the United States. On May 19, President Obama announced new, stricter nationwide CAFE standards to take effect in 2012. Additionally, several states have proposed low-carbon fuel standards, which require fuel suppliers to reduce the carbon their fuel emits by increasing the use of nonpetroleum fuels, such as ethanol or biofuels. President Obama also supports a national low-carbon fuel standard. Again, federal climate change legislation will raise questions about the place for these programs

in a national market-based cap-and-trade system as well as questions regarding whether these state programs can or should exist alongside federal regulation.

CONCLUSION

While momentum for federal regulation of greenhouse gas emissions is building, Congress faces significant challenges in crafting a system that will be both effective and efficient. In addition to designing federal climate change legislation, Congress will also need to address the role, if any, of other sector-specific regulations, such as Renewable Energy Portfolios, CAFE standards, and low-carbon fuel standards. Finally, any federal program will need to address preemption issues, because states have largely taken the lead, to date, on greenhouse gas regulation. In the end, the patchwork of state programs may provide the impetus and framework for federal regulation while ultimately proving unnecessary if a comprehensive federal program is enacted. ■

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¹ President Barack Obama Inaugural Address (Jan. 20, 2009), available at <http://www.whitehouse.gov/blog/inaugural-address>. (Web sites last visited June 1, 2009.)

² See, e.g., U.S. Climate Action Partnership Blueprint for Legislative Action (Jan. 15, 2009), available at <http://www.us-cap.org/blueprint>.

³ See, e.g., *id.* at 2; Obama Agenda—Energy and Environment, available at http://www.whitehouse.gov/agenda/energy_and_environment; Memorandum from Rick Boucher and John Dingell to Members, Committee on Energy and Commerce regarding Climate Change Discussion Draft, at 2 (Oct. 7, 2008).

⁴ Obama Agenda—Energy and Environment, *supra* note 3.