



## HOUSE PASSES WAXMAN-MARKEY CLIMATE CHANGE BILL

Late on Friday, June 26, 2009, as Congress was about to leave Washington for its Fourth of July recess, the House of Representatives passed, by a margin of 219 to 212, *The American Clean Energy and Security Act of 2009 (H.R. 2454)*, authored by Congressmen Henry Waxman of California and Edward Markey of Massachusetts. The 1,428-page Waxman-Markey bill would establish a “cap and trade” program to regulate U.S. greenhouse gas emissions and would create or expand myriad federal programs designed to transform an economy based on energy produced almost entirely by burning fossil fuels—oil, coal, and natural gas—to one based almost entirely on alternative energy sources. To accomplish the latter goal, the bill proposes to spend about \$200 billion to promote various forms of “clean energy” and energy efficiency while establishing new federal climate change standards affecting many aspects of everyday life, such as local building codes, mortgages, and homeowners insurance.

### U.S. GREENHOUSE GAS EMISSIONS WOULD BE REDUCED TO 17 PERCENT OF 2005 LEVELS BY 2050

The bill seeks to reduce “greenhouse gas” emissions (largely carbon dioxide from burning fossil fuels) via a cap and trade system for larger emitters and a traditional Clean Air Act approach for smaller emitters. Although the cap and trade requirements would generally apply only to sources responsible for emissions of at least 25,000 tons per year, the bill sets no emission threshold for power plants and certain industries. In addition, the bill authorizes U.S. EPA to apply traditional Clean Air Act “new source performance standards” to uncapped sources emitting as little as 10,000 tons per year. Beginning in 2020, U.S. EPA would be required to evaluate and lower the cap and trade threshold to as low as 10,000 tons per year, if it determines that even greater reductions in greenhouse gas emissions can be “cost-effectively achieved” by lowering the threshold.

**Cap and Trade.** The “cap” in “cap and trade” consists of a series of annually decreasing limits on overall U.S. greenhouse gas emissions, beginning in 2012 and reaching a 17 percent reduction (compared to 2005 levels) by 2020 and an 83 percent reduction by 2050. The bill would initially apply to electric utilities, fuel refineries, and certain industries (representing 66 percent of total U.S. emissions), with additional industrial sources covered in 2014 and natural gas distributors added in 2016, ultimately bringing about 85 percent of U.S. greenhouse gas emissions within the cap and trade system.

U.S. EPA would distribute emission allowances (collectively equal to the annual overall emissions cap) among affected emitters, who must annually collect enough allowances or offset credits (described below) to equal their actual emissions. Reflecting the practicalities of regulating something as ubiquitous as carbon dioxide, some emissions are regulated directly at the point of emission, while others are regulated indirectly via obligations on fossil fuel suppliers. For example, while electric power plants are directly responsible for their greenhouse gas emissions, the more diffuse greenhouse gas emissions from autos and other vehicles are regulated through a requirement that fuel producers and importers obtain allowances equal to the emissions attributable to the fuels they distribute in commerce.

Initially, about 70 percent of available allowances would be allocated among affected industries for free, reducing compliance costs that would otherwise be passed on to consumers, and about 30 percent would be auctioned to raise funds for assistance to low-income energy consumers. Over time, the percentage of allowances being auctioned would increase until reaching about 70 percent for 2031 and the years after. The Obama administration had requested that 100 percent of the allowances be auctioned from the start, which would have immediately created a new federal revenue stream of around \$80 billion per year.

The House bill includes guidelines for allocating free allowances among the affected industries. For example, electric utilities would initially receive 43.75 percent of the available allowances for free, petroleum refiners would initially receive 2.25 percent of the allowances, home heating oil and propane suppliers would initially receive 1.875 percent, and local

natural gas suppliers would receive nine percent of the allowances for free in 2016 (the first year that emissions from their product are addressed by the cap).

The “trade” in “cap and trade” occurs when those with extra emission allowances or offset credits sell them via commodity-like “carbon markets” to those who need more. In theory, the opportunity to buy and sell credits minimizes the overall cost of compliance, as those emitters that can reduce emissions more cheaply than the market price do so and sell the credits at a profit to those emitters who cannot. Trading would not be limited to covered sources, so institutional investors, such as hedge funds, are expected to participate. Although each allowance would carry a designated “vintage year,” they could be banked (*i.e.*, held for use in a future year) indefinitely and could be borrowed (*i.e.*, used as much as five years in advance of their vintage year) under certain circumstances.

**Offset Credits.** The bill allows capped sources to use “offset credits” to meet a portion of their annual compliance obligations. Offsets are generated by projects that reduce, avoid, or sequester emissions that would otherwise not be subject to the emissions cap. For example, capturing and destroying methane released from a landfill or installing wind turbines in a developing country might qualify as offset projects. A number of provisions in the bill restrict the attractiveness of offset projects, and U.S. EPA was originally responsible for managing the program. However, in the last-minute amendments needed to attract enough votes to pass the bill, the Department of Agriculture was authorized to implement a parallel program to issue offset credits for a broad range of agricultural projects, from altered tillage practices to dietary modifications for livestock to reduce flatulence. Finally, the bill includes provisions designed to provide offset credits to sources that have already taken “early action” to reduce their emissions.

**Auction Process.** Under the bill, U.S. EPA would conduct quarterly auctions of emissions allowances using a single-round, sealed bid, uniform price format. Each auction would seek to sell one-quarter of that year’s available allowances under the cap, along with a portion of the allowances for vintage years two to five years away and 12 to 17 years away. The minimum reserve price for vintage year 2012 allowances

would be \$10 and would increase each year thereafter. Except for a special reserve of allowances available only to small refiners and a “strategic reserve” to address price spikes, the auctions would be open to any and all bidders, with the identities of the bidders and the auction results made public. No bidder could purchase more than 5 percent of the available allowances.

**Greenhouse Gas Monitoring.** Many aspects of the bill's greenhouse gas program, from allocating free emission allowances to ensuring that emitters have collected sufficient allowances to cover their actual emissions, require comprehensive and timely emissions data. Accordingly, the bill directs U.S. EPA to adopt regulations requiring emissions monitoring by sources emitting 10,000 tons of greenhouse gases per year or more (including continuous emissions monitoring, or its functional equivalent, for the 25,000-ton emitters covered by the cap and trade program), and to report those results to the government on a quarterly basis. In contrast, a greenhouse gas monitoring rule proposed by U.S. EPA earlier this year would apply only to 25,000-ton emitters and would require continuous monitoring only for those sources already doing so.

**State and Regional Programs.** Waxman-Markey prohibits other greenhouse gas cap and trade programs, such as the existing Regional Greenhouse Gas Initiative among 10 northeastern states, from operating for a period of five years but includes provisions designed to compensate emitters that already hold allowances and offset credits issued under such programs. The bill permits states to regulate greenhouse gas emissions through other means, such as through vehicle emission limits and low-carbon fuel standards.

**International Considerations.** The bill links the U.S. program to the existing international carbon market established under the Kyoto Protocol by generally allowing companies to meet their U.S. obligations using allowances and offset credits issued under international programs approved by U.S. EPA. The bill also sets aside a pool of allowances to be rebated to companies in “energy intensive, trade-exposed” industries, and it includes a controversial provision aimed squarely at China and India that would require the President to impose “border adjustments” (*i.e.*, tariffs) to protect such companies from competitors in countries that do not implement equally

stringent controls on their industry. The latter provision, which many fear could spark a trade war, could be waived only by a joint resolution of Congress.

**Citizen Suits.** The bill would expand the Clean Air Act's existing citizen suit provision to permit private enforcement suits based on violations of the new greenhouse gas emissions requirements.

## TO ACHIEVE CAP AND TRADE GOALS, WAXMAN-MARKEY SEEKS TO TRANSFORM U.S. ENERGY PRODUCTION AND USE

Just as the cap and trade portion of Waxman-Markey seeks to dramatically reduce U.S. emissions attributable to fossil fuel use, the remainder of the bill seeks to dramatically redirect U.S. energy production, transmission, and use toward alternative sources of energy. Most notably, the bill requires electric utilities to meet 20 percent of demand by 2020 through renewable energy and energy efficiency measures.

To support this mandate and related goals for the transportation and building sectors, the bill creates or modifies myriad federal programs and offices to disburse about \$200 billion to modernize the country's electric grid, develop various forms of “clean energy,” and promote energy efficiency. Combined with the substantial appropriations in the February 2009 economic stimulus bill for various energy initiatives, climate change legislation would open up significant new investment opportunities for companies in all types of renewable energy, along with advanced power transmission and storage.

Reflecting the fact that energy use underpins virtually every aspect of daily life, the bill's provisions reach well beyond energy producers and industrial users. The bill seeks to affect consumer energy consumption via expanded federal involvement in the energy efficiency of both cars and consumer appliances, as well as by shaping the terms of everything from building codes to mortgages to homeowners insurance.

## MEETING WAXMAN-MARKEY'S MANDATES WOULD PRESENT CHALLENGES

Meeting the annual emissions caps imposed by Waxman-Markey would require a dramatic reversal of historic trends in U.S. fossil fuel use. From the beginning of the industrial revolution to today, economic growth has been tied to growth in energy consumption, and that energy has almost all come from burning fossil fuels. The bill would require such use to begin declining almost immediately and to steadily decrease for a generation.

Improvements in energy efficiency could deliver a portion of the mandated decrease in the near term, but long-term economic growth would still require abundant, cost-effective “low carbon” energy sources that do not currently exist. In interviews following the House vote, both President Obama and the Secretary of Energy, Steven Chu, expressed confidence that with the benefit of significant government financial support, future technological breakthroughs will occur in time to meet the requirements of the bill.

While the cap and trade approach has been successfully used to regulate and reduce the sulfur dioxide emissions from coal-fired power plants that produce “acid rain,” neither the Commodity Futures Trading Commission nor any other U.S. agency has ever attempted to manage a derivatives market of the size that would be created by Waxman-Markey. Trading in greenhouse gas emission allowances and offset credits would generate a derivatives market valued at as much as a trillion dollars. While linkage to international carbon markets makes economic sense, it also increases the complexity of the administrative challenge. In light of the regulatory fallout from the recent economic collapse, many will question whether the federal government is up to the task.

## POLITICAL CIRCUMSTANCES MAY ENHANCE THE ATTRACTIVENESS OF A NON-LEGISLATIVE APPROACH

The narrow margin of victory in the House—where the Democrats commanded a comparable majority and fewer parliamentary obstacles than in the Senate—demonstrated

the absence of legislative consensus on this issue. Although it might otherwise be politically advantageous for the administration to shift its near-term focus (and political capital) to other policy priorities, such as health care legislation, and defer climate change regulation for at least a year, external events might make that impractical. This December, members of the United Nations Framework Convention on Climate Change plan to meet in Copenhagen to negotiate the global climate change treaty to replace the Kyoto Protocol when it expires in 2012. President Obama wishes to take a leadership role in those negotiations. To do so, the President needs clear progress on domestic climate change regulation by December.

The uncertain Congressional support for climate change legislation casts doubt on whether the administration can rely on Congress to provide the mandate desired in the run-up to Copenhagen. As controversial as Waxman-Markey was in the U.S., the international community already has signaled that it does not go far enough. For example, the greenhouse gas reductions mandated by the bill—even if fully achieved—would still fall short of the level of reduction that the Intergovernmental Panel on Climate Change says is necessary to limit global warming to a 2°C increase and prevent significant environmental impacts. Moreover, while the European Union has committed to reduce its greenhouse gas emissions by 20 percent, compared to 1990 levels, by 2020, Waxman-Markey's 2020 cap represents only a 3.5 percent reduction of U.S. emissions compared to 1990.

Faced with the likelihood of even further compromises in the Senate and uncertainty over the pace at which the legislation will proceed, the administration may be drawn to an option that does not require Congressional involvement: regulation of greenhouse gases as “pollutants” under U.S. EPA's existing Clean Air Act authority. The Supreme Court confirmed such authority in *Massachusetts v. Environmental Protection Agency*, 549 U.S. 497 (2007), and the Obama administration has been aggressively laying the groundwork necessary to implement that authority. Since the Clean Air Act was not designed to address this sort of problem, the conventional wisdom has been that these efforts were an attempt to spur legislative action. However, the narrow margin of passage in the House suggests that this may be the approach most likely to achieve President Obama's policy objectives.

There are several reasons to believe that the Clean Air Act approach might ultimately appeal to the Obama administration. First, the administration has demonstrated in other major policy decisions a desire for quick action. Under a Clean Air Act approach, the administration would be able to control the timetable for climate change rulemaking and could sweep aside, at least initially, any objections to its proposal via “public notice and comment” procedures. Second, the administration has demonstrated that it is comfortable with its ability to craft entirely new regulatory programs on its own, and it might even prefer this approach to simply implementing schemes devised by Congress. Third, rulemaking would allow the administration to minimize the political compromises necessary to pass legislation and could deliver the sort of stringent greenhouse gas requirements necessary to stand shoulder to shoulder with like-minded foreign governments in Copenhagen.

The administration’s plans should become apparent over the next couple of months. The public comment period on [U.S. EPA’s proposed finding](#) that greenhouse gas emissions “endanger public health and welfare,” a prerequisite to conventional Clean Air Act regulation, closed on June 23, 2009, and U.S. EPA rejected multiple requests to extend the comment period. The scope and pace of U.S. EPA’s action on the endangerment assessment and related measures, along with the scope and pace of the Senate’s action on climate change legislation, will gradually illuminate the Obama administration’s chosen path to Copenhagen in December.

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