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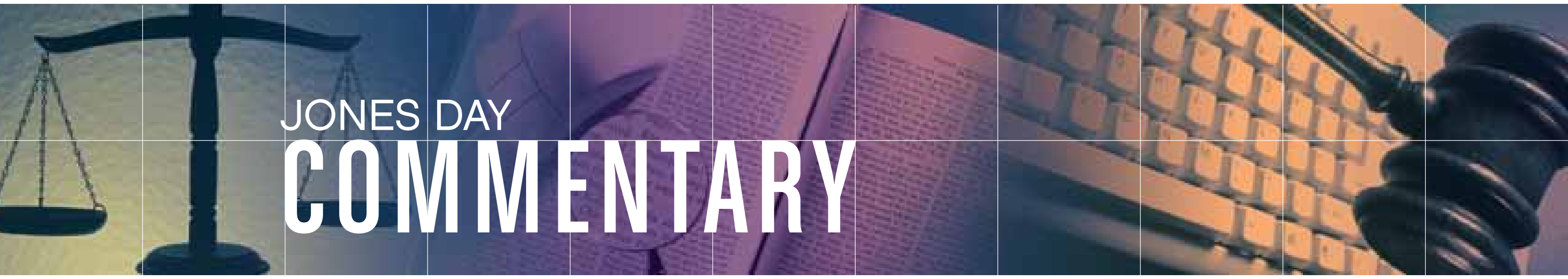

OVERVIEW OF CALIFORNIA'S PRELIMINARY DRAFT CAP AND TRADE PROGRAM

The California Air Resources Control Board ("CARB") released its preliminary draft regulation ("PDR") for a California cap and trade program on November 24, 2009. This is an incredibly ambitious, far-reaching, and complex program that, if adopted, will affect virtually every company that does business in California.

Under California's Global Warming Solutions Act ("AB 32"), California must reduce greenhouse gas ("GHG") emissions to 1990 levels by 2020. The AB 32 Scoping Plan adopted by CARB calls for a California cap and trade program that links with other regional partner jurisdictions in the Western Climate Initiative ("WCI") to create a regional market system. As adopted in the Scoping Plan, the cap and trade program would establish a cap covering about 85 percent of California's GHG emissions and allow trading to promote cost-effective emissions reductions. The cap and trade regulation will set up the framework and requirements for participation in the cap and trade program.

The PDR reflects the approach to cap and trade approved by CARB in the AB 32 Scoping Plan. This approach includes:

- Requiring sources of GHG emissions to manage their emissions under an aggregate declining emissions cap that supports achieving the 2020 emissions target mandated by AB 32.
- Starting the program in 2012 with about 600 of the state's largest GHG-emitting stationary sources (primarily industrial sources and electricity generators), along with electricity imports.
- Including emissions from transportation fuel combustion (*e.g.*, gasoline, diesel, and ethanol) and from fuel combustion at stationary sources that fall below the threshold for direct inclusion in the program (*e.g.*, residential and commercial natural gas combustion) by covering the suppliers of fuel to these sources.

- Requiring a minimum number of allowances to be auctioned at program start.

- Allowing limited use of high-quality offsets outside of capped sectors to cover a portion of the overall emissions reductions.

- Establishing rules for emissions trading, monitoring, and enforcement.

CARB's intent is for the cap and trade program to "include a stringent declining emissions cap. Emissions trading and the limited use of offsets would provide flexibility for covered entities to comply."

In CARB's proposed cap and trade program, a limit, or *cap,* would be put on the amount of pollutants (GHGs) that can be emitted. Each allowance would equal one metric ton of carbon dioxide equivalent. The total number of allowances created would be equal to the cap set for cumulative emissions from all the covered sectors. These allowances could be auctioned and/or freely given to companies or other groups. In addition to allowances, a limited amount of emissions reductions from sources that are outside the cap coverage, called *offsets*, could be authorized. This would allow emissions in the capped sectors to slightly exceed the allowances issued. The term *compliance instruments* would cover both allowances and offsets. After initial distribution of allowances, compliance instruments could be traded among entities. At the end of each *compliance period*, covered entities would be required to turn in, or *surrender*, enough compliance instruments to match their emissions during this time period.

The PDR contemplates setting a cap for each compliance period, the first of which would begin on January 1, 2012. Compliance periods could be three years in duration (*e.g.*, 2012 to 2014, 2015 to 2017, and 2018 to 2020). CARB is considering requiring entities to surrender a portion of their reported emissions each year during the three-year compliance period and shortening the compliance period to one year.

CARB also is considering how to phase sectors into the program. Under the staggered approach that was outlined in the Scoping Plan, entities in the following sectors would be covered in the program according to the following timelines:

Starting in the first compliance period (2012):

- Electricity generation, including imports

- Large industrial sources and processes at or above 25,000 $MTCO_2e$

Starting in the second compliance period (2015):

- Industrial fuel combustion at facilities with emissions below 25,000 $MTCO_2e$, and all commercial and residential fuel combustion of natural gas and propane

- Transportation fuels

Under the PDR, the emissions cap would decline every year and, as a result, fewer allowances would be issued. At the end of a compliance period, each covered entity would be required to surrender allowances, and some offsets, equal to its total GHG emissions during that compliance period. Once the allowances are surrendered, they would be permanently retired by CARB. Failure by a covered entity to surrender sufficient allowances to match its emissions would result in significant penalties.

Once an entity holds an allowance, it could either: 1) surrender it to comply with its obligation under the regulation; 2) bank it for future use; 3) trade it to another entity; or 4) ask CARB to retire it. Because allowances can be traded—that is, bought and sold—they potentially have a significant economic value. Thus, CARB is considering different approaches for allocation and auction design and is receiving input from a panel of economic, financial, and policy experts.

Under CARB's proposed cap and trade program, covered entities could buy offset credits in lieu of buying allowances or reducing their emissions on-site. Offsets are tradable credits that represent GHG emissions reductions that are made in areas or sectors not covered by the cap and trade program. One offset credit would be equal to one metric ton of GHG emissions. Offsets would have to meet rigorous criteria that demonstrate that the emissions reductions are real, permanent, verifiable, enforceable, and quantifiable. To be credited as an offset, the action or project would have to be additional to what is required by law or regulation or would otherwise have occurred. Under a California cap and trade program, CARB could issue or approve an offset credit that could be used by a covered entity instead of turning in an allowance for the equivalent amount of CO_2e emitted.

Because the Scoping Plan called for a limited use of offsets, the PDR includes a proposal that a covered entity be allowed to use offsets for up to 4 percent of what it surrenders at the end of a compliance period.

The PDR also includes a preview of upcoming regulatory revisions to CARB's Mandatory Reporting regulations for GHGs to accommodate a wider range of facilities and entities than are currently required to report their emissions. More detailed proposed regulatory language for mandatory reporting will be released in the spring of 2010.

The regulatory text for the cap and trade program can be found here: http://www.arb.ca.gov/cc/capandtrade/meetings/121409/pdr.pdf.

CARB intends to prepare a proposed regulation and preliminary staff report for public comment in spring 2010, with a final proposed draft regulation available for public review in summer 2010.

The Board is scheduled to consider the final draft at its October 2010 meeting.

LAWYER CONTACT

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