CALIFORNIA ADOPTS CAP AND TRADE PROGRAM FOR GREENHOUSE GAS EMISSIONS

On December 16, 2010, the California Air Resources Board ("CARB") approved a resolution ordering its Executive Officer to proceed with finalizing cap and trade regulations for greenhouse gas ("GHG") emissions in California. Once underway, California's cap and trade program may serve as a test case for other states and the nation. Other programs, like the Climate Action Reserve and the Regional Greenhouse Gas Initiative, have established GHG markets in the United States that are voluntary in nature or that are mandatory for only a single sector of the economy. CARB's program, however, represents the first cap and trade program for GHG emissions that is mandatory for numerous sectors of a state economy.

The CARB resolution also calls for certain changes to the proposed regulations and the undertaking of various tasks to finalize and implement the cap and trade program. CARB plans to move quickly toward establishing the cap and trade program and will provide just 15 days of public comment on any future proposed changes to the regulations. CARB also expects to provide a follow-up report by July 31, 2011 on its progress toward implementing the program and resolving various open items.

BACKGROUND

California's Global Warming Solutions Act of 2006 (AB 32) requires CARB to develop and implement a plan to reduce GHG emissions to 1990 levels by 2020. In December of 2008, CARB adopted a Scoping Plan to implement AB 32. The Scoping Plan calls for CARB to develop a range of GHG emission reduction measures, including a cap and trade program that links with other regional partner jurisdictions in the Western Climate Initiative ("WCI"). California, six other western states, and four Canadian provinces formed the WCI in 2007 to establish a regional market for reducing GHG emissions.

On November 14, 2009, CARB released a preliminary draft regulation setting forth a conceptual framework for a cap and trade program in California. After considering public comments, CARB issued more details for the program in its proposed regulations on October 29, 2010. As modified by the draft resolution on December 16, the proposed regulations reflect CARB's most recent proposal for a cap and trade program to date.

APPLICABILITY

EMISSIONS

The program covers emissions of carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_20), sulfur hexafluoride (SF_6), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), nitrogen trifluoride (NF_3), and other fluorinated GHGs. Emissions may be calculated using either CARB's or U.S EPA's GHG protocols and are measured on a per metric ton carbon dioxide equivalent basis ($MTCO_2e$). Although reporting requirements apply at the outset of California's cap and trade program, the obligation of covered entities to submit compliance instruments equivalent to their emissions will commence in two phases. Compliance instruments consist of allowances, offset credits, and sector-based offset credits (as more fully described below).

COVERED ENTITIES

Compliance Obligations Commencing 2012

In the first phase of the program, the covered entities listed in the following table will be subject to compliance obligations commencing on January 1, 2012 if their annual GHG emissions in any year from 2008 to 2010 meet or exceed the applicable thresholds.

COVERED ENTITIES COMMENCING 2012	ANNUAL THRESHOLD ($MTCO_2e$)
Entities having operational control of electric generating facilities located in California.	25,000
Importers of specified sources of electricity into California.	25,000
Importers of unspecified sources of electricity into California.	0 (no threshold)
Operators of facilities located in California that engage in any of the following operations: (1) Cement production, (2) Cogeneration, (3) Glass production, (4) Hydrogen production, (5) Iron and steel production, (6) Lime manufacturing, (7) Nitric acid production, (8) Oil and natural gas systems, (9) Petroleum refining, (10) Pulp and paper manufacturing, (11) Self-generation of electricity, and (12) Stationary combustion.	25,000
Producers, importers, and exporters of CO_2 into/out of California.	25,000

The first three categories of covered entities are collectively referred to as "first deliverers" of electricity. Within this group, an "electricity importer" is any marketer or retail provider that holds title to electricity generated outside of California and delivered to serve load inside California. When the initial electricity importer is not subject to CARB's jurisdiction, such as in the case of a tribal nation, the program applies to the first entity in California that takes delivery of the imported electricity and is subject to CARB's jurisdiction.

Importers of electricity from "unspecified sources" are included in the program regardless of their emissions, whereas importers from "specified sources" are subject to a threshold during the first compliance period. A source of electricity is "unspecified" when it cannot be matched to a specific generation facility or unit or an asset-controlling supplier recognized by CARB, and a source is "specified" when the importer can claim a specific facility or unit as the source of imported electricity.

Compliance Obligations Commencing 2015

In the second phase of the program, the covered entities listed below will be subject to compliance obligations commencing on January 1, 2015 if their annual GHG emissions in any year from 2011 to 2014 meet or exceed the applicable thresholds. Certain fuel suppliers will be added to the list of covered entities starting in 2015, while the threshold for importers of electricity from specified sources will no longer apply.

COVERED ENTITIES COMMENCING 2015	ANNUAL THRESHOLD ($MTCO_2e$)
Entities having operational control of electric generating facilities located in California.	25,000
Importers of specified and unspecified sources of electricity into California.	0
Operators of facilities located in California that engage in any of the activities covered during the first phase of the program.	25,000
Producers, importers, and exporters of CO_2 into/out of California.	25,000
Entities that distribute or use natural gas in California as follows: – public utility gas corporations – publicly owned natural gas utilities – operators of other intrastate pipelines that distribute natural gas directly to end users.	25,000
Suppliers of RBOB and Distillate Fuel Oil.	25,000
Suppliers of Liquefied Petroleum Gas.	25,000

Suppliers of Reformulated Blendstock for Oxygenate Blending (RBOB) and Distillate Fuel Oil include (i) entities that hold an inventory position in motor vehicle fuel, ethanol, distillate fuel, biodiesel, or renewable diesel as reflected in the records of a terminal operator or terminal operators that own motor vehicle fuel or diesel fuel in a terminal and (ii) entities that import motor vehicle fuel, diesel fuel, ethanol, biodiesel, or any other biomass-derived fuel or renewable fuel and who are the importers of record under federal customs law or the owners of fuel upon import if the fuel is not subject to federal customs law.

Suppliers of Liquefied Petroleum Gas include (i) operators of refineries that produce liquid petroleum gas in California, (ii) operators of facilities that fractionate natural gas liquids to produce liquid petroleum gas, and (iii) consignees of liquefied petroleum gas into California.

EXCLUDED EMISSIONS

Emissions from certain sources are excluded from the cap and trade program and will not count toward the program's applicability thresholds or compliance obligations, even though the emissions may need to be counted toward reporting thresholds under CARB's Regulation for the Mandatory Reporting of Greenhouse Gas Emissions. These "emissions without a compliance obligation" may include emissions from (i) certain biomass-derived fuels, (ii) biodiesel and fuel ethanol derived from certain agricultural sources, (iii) certain municipal solid waste,

(iv) biomethane from certain sources, and (v) certain sources that are fugitive in that they are unintentional and could not reasonably pass through a stack, chimney, vent, or other functionally equivalent opening.

COMPLIANCE PERIODS

The program has three compliance periods: 2012–2014, 2015–2017, and 2018–2020. Once a covered entity becomes subject to a compliance obligation in a compliance period, the covered entity will have a compliance obligation for each year of that same period. Covered entities subject to annual thresholds may exit the program in a subsequent compliance period if annual reports demonstrate that past emissions were less than 25,000 $MTCO_2e$ per year during an entire compliance period. Also, a covered entity may exit the program if it shuts down all processes, units, and supply operations subject to GHG emissions reporting.

VOLUNTARY PARTICIPATION

In addition to mandatory participation by covered entities, CARB's proposed cap and trade program allows other entities to participate voluntarily. Entities listed above whose emissions do not meet or exceed an applicable emissions threshold may choose to participate in the program as an "opt-in covered entity." Once included, opt-in entities are subject to all the same compliance obligations as covered entities (and references to covered entities hereafter will include opt-in covered entities).

Another category of voluntary participants consists of those interested parties known as "voluntarily associated entities" that do not have a compliance obligation but may want to purchase, hold, sell, or voluntarily retire compliance instruments. Examples of potential voluntarily associated entities include nongovernmental organizations, private individuals, traders, brokers, emission offset providers, and financial institutions. CARB expects these voluntary participants to increase liquidity in the market and facilitate the buying and selling of compliance instruments.

A third category of voluntary participants are "other registered participants" who register with the accounts administrator under the California program but may not purchase or hold compliance instruments. This category includes data verifiers, verification bodies, offset project registries, and other registered third parties.

MARKET DESIGN

CAP

Consistent with the archetype for cap and trade programs, CARB's regulations include a statewide cap, or "budget," on annual GHG emissions. The budget is reduced each year to achieve a statewide reduction in emissions over time. In 2012, the first year of the program, CARB has set the initial budget at 165.8 million $MTCO_2e$, which is the level of emissions forecasted for covered entities that year. The budget will then decline approximately 2 percent per year between 2012 and 2014. In 2015, the budget peaks at 394.5 million $MTCO_2e$ with the inclusion of fuel suppliers and additional electricity importers as covered entities. The budget will then decline by approximately 3 percent per year, eventually dropping to 334.2 million $MTCO_2e$ in 2020. Overall, the budget will decline to a level in 2020 that is designed to support AB 32's goal of reducing GHG emissions to 1990 levels by 2020.

COMPLIANCE INSTRUMENTS

Compliance instruments consist of allowances, offset credits, and sector-based offset credits (with references to offset credits hereafter to include sector-based offset credits). A covered entity must fulfill its triennial compliance obligation by surrendering compliance instruments equal to its total GHG emissions during a compliance period. CARB will also require covered entities to fulfill annual compliance obligations by surrendering compliance instruments equal to 30 percent of their prior year reported emissions during each of the first two years of a compliance period to reduce the risk of noncompliance at the end of the three-year period. For a detailed analysis of the theoretical framework of cap and trade programs (including the interrelationship among allowances, offset credits, and renewable energy credits), readers may refer to the Jones Day White Paper entitled "Market Design of Allowances, Offsets, and Renewable Energy Credits in the U.S. Carbon Markets" (available at www.jonesday.com/market_design_of_allowances).

ALLOWANCES

Under California's cap and trade program, an allowance is a limited tradable authorization to emit up to one metric ton of carbon dioxide equivalent. The cap determines the total number of allowances issued by CARB. During the initial years of the program, the majority of allowances will be allocated to covered entities for free, with a small portion of the remaining allowances to be auctioned (or allocated to an Allowance Price Containment Reserve or other set-asides). Ultimately, the balance of distributions will shift from allocations of free allowances to sales of allowances via auctions, with the percentage of free allocations reducing and the percentage of auctioned allowances increasing over time.

Allocations

Initially, free allocations will be directed to (i) the covered entities in the industrial sectors listed in the table below, (ii) investor owned utilities, and (iii) publicly owned electric utilities. CARB is also considering expanding these free allocations to natural gas distribution utilities when they become subject to compliance obligations in the second compliance period and have inserted a placeholder in the regulations for this potential.

INDUSTRIAL SECTORS RECEIVING FREE ALLOWANCE ALLOCATIONS	
Oil and gas extraction	Sawmills
Natural gas liquid extraction	Petroleum refining
Soda ash mining and manufacturing	Pesticide and agricultural chemical manufacturing
Reconstituted wood product manufacturing	Polystyrene foam product manufacturing
Paper manufacturing	Gypsum product manufacturing
Paperboard manufacturing	Mineral wool manufacturing
All other basic inorganic chemical manufacturing	Rolled steel shape manufacturing
Flat glass manufacturing	Secondary smelting and alloying of aluminum
Glass container manufacturing	Secondary smelting, refining, and alloying of nonferrous metal (except copper and aluminum)
Cement manufacturing	Iron foundries
Lime manufacturing	Turbine and turbine generator set units manufacturing
Iron and steel mill	Pharmaceutical and medicine manufacturing
Food manufacturing	Aircraft manufacturing
Cut and sew apparel manufacturing	
Breweries	

With respect to the covered entities in the listed industrial sectors, the allocation of free allowances will be based on (i) their production activities in recent years compared with a sector-specific benchmark in order to incentivize continued in-state production (*i.e.*, the more a facility produces, the more free allowances it receives) and (ii) their efficiency of production compared with a sector-specific benchmark in order to incentivize early action and investment in energy efficiency and GHG emission reductions (*i.e.*, based either on a product-based benchmark that measures emissions performance on a per-unit-of-output-basis or a thermal energy-based benchmark that measures the efficiency of a facility's use of energy such as natural gas).

Free allocations of allowances will also be directed to investor owned and publicly owned electric distribution utilities. For investor owned utilities, the free allowances allocated to them must be consigned for sale at the general quarterly auctions of allowances, with the proceeds from the sales of these consigned allowances used by the utility exclusively to mitigate any increased costs for their distribution customers. By requiring investor owned utilities to consign their free allowances for auction, and compelling them to obtain allowances for compliance by purchasing them through the auctions as buyers or from the secondary market, CARB is looking to maintain the competitiveness of the deregulated electricity market in California by placing utility-owned generation and independent generation on equal footing when it comes to purchasing allowances for compliance. In contrast, most publicly owned utilities own and operate their own generation and do not compete with independent generators in the way investor owned utilities do. Because of this, publicly owned utilities have the option under the program to either consign their free allowances for sale at the general quarterly auctions or to directly use their free allowances to meet their compliance obligations.

There is a placeholder in the regulations for the methodology by which CARB determines the amount of free allowances to be allocated to investor owned utilities and publicly owned utilities. The diversity of resources and emissions-reduction opportunities among utilities creates challenges for CARB in defining a methodology for allocating free allowances that provides appropriate incentives that are effective, affordable, and equitable among all utilities. Regulators are faced with a landscape in which utilities operate under significantly divergent circumstances, with utilities in southern California more reliant on coal-fired generation with long-term contractual commitments and those in northern California more reliant on natural gas and hydroelectric resources. One of the leading methodologies considered by CARB is to account for both historical emissions and electricity sales. Historical emissions would recognize the diversity of generating resources across utilities, while electricity sales would reflect differences in the amount of electricity delivered by the utilities. CARB is also reviewing additional factors such as the dates of contract expirations, the rate of achievement of renewable and other low-emitting resources, and incentives for early reductions in commitments for high-emitting resources.

Auctions

CARB anticipates that a gradual shift from free allocations to auctioned allowances will minimize start-up costs by allowing time for covered entities to reduce emissions. By limiting costs in the program's early years, CARB hopes to minimize the risk of covered entities avoiding regulation under the program by shifting production outside of California in a phenomenon known as "leakage." General auctions will be held quarterly, and covered entities and voluntarily associated entities may bid for allowances. The reserve price has been set at $10/metric ton for auctions in 2012. For all years following 2012, this reserve price will be increased by 5 percent plus an adjustment for inflation that is pegged to the consumer price index.

In addition to auctioning allowances for a current compliance period, CARB will hold advance auctions of a portion of the allowances budgeted for future years. The goal of advance auctioning, according to CARB, is to send price signals to the market about the expectation of future allowance prices. CARB expects advance auctioning to benefit and facilitate long-term investments in the market. Allowances for future compliance periods sold at an advance auction can be held or traded, but they may not be used to satisfy compliance obligations for covered entities until the actual vintage year of the allowance has been reached. The restriction against using advance auction allowances for current compliance is intended to prevent "cascading borrowing," where the use of future allowances for current compliance creates a shortage of compliance instruments in later compliance periods.

Allowance Price Containment Reserve

To minimize the potential for upward spikes in allowance prices, CARB will establish a reserve supply of allowances in an Allowance Price Containment Reserve. This reserve will hold allowances that will be made available for purchase by covered entities (and not voluntarily associated entities) at fixed prices at direct quarterly reserve sales held three weeks after each general auction. Allowing covered entities to purchase allowances from the reserve at fixed prices will help contain their exposure to high market prices. The reserve will be organized into three tiers, with allowances in each tier available for purchase at fixed prices. For 2012, allowances in the first, second, and third tiers are set at $40/metric ton, $45/metric ton, and $50/metric ton, respectively. These prices will escalate by 5 percent plus an adjustment for inflation that is pegged to the consumer price index. The administrator of the auction will conduct sales from each tier in succession, from the lowest to the highest price tiers. These allowances purchased from the reserve can be used only for compliance and cannot be further resold.

Auction Purchase Limits and Holding Limits

A variety of measures under the program are designed to prevent market manipulation. Auction purchase limits restrict the share of allowances of any vintage year that may be purchased at any quarterly auction from 2012 through 2014 by one entity or a group of affiliated entities. For covered entities, this limit is 10 percent of the total amount of allowances offered for auction, and for other auction participants, the limit is 4 percent. The auction purchase limit will not apply to investor owned electric utilities that receive a direct allocation of allowances from CARB.

In addition to the auction purchase limits, a holding limit will restrict the share of total allowances that registered market participants can maintain in their holding accounts (*i.e.*, the accounts used to hold allowances for sales or that are purchased). Affiliated entities will be evaluated under this limit as if they belonged to a single entity. The holding limit, however, will not apply to compliance accounts of covered entities up to the amount of an account holder's most recent verified emissions. The holding limit is calculated by a formula under the regulations that is referenced to each year's cap.

OFFSETS

Offset Credits

Under California's cap and trade program, an offset credit is a tradable compliance instrument that represents a GHG reduction or GHG removal of one metric ton of carbon dioxide equivalent. Offset credit can be generated from projects that achieve reductions or removal of GHG from activities that are not otherwise regulated or covered under California's cap and trade program. The purpose for permitting offset credits is (i) to increase compliance flexibility by permitting covered entities to surrender offset credits in lieu of allowances, (ii) to function as a limited cost-containment mechanism because offsets credit are expected to cost less than allowances, and (iii) to stimulate development of innovative projects and technologies to reduce GHG emissions from sources outside the capped sectors under the program.

In order for an offset project to be eligible to receive offset credits, the offset project developer must demonstrate that the GHG reductions or removal are real, additional, quantifiable, permanent, verifiable, and enforceable. Specifically with respect to the requirement for additionality, GHG reductions must result from activities that:

1. are not required by or undertaken to comply with any federal, state, or local law or ordinance;
2. are not considered common practice or would not have occurred under a business-as-usual scenario;
3. were not commenced prior to January 1, 2007;
4. exceed a project baseline calculated by a protocol for an offset project of that type; and
5. are located in the U.S., Canada, or Mexico.

An offset project developer must also comply with one of the protocols approved by CARB. There are currently four protocols approved under the regulations:

1. *U.S. Ozone Depleting Substances (ODS) Projects Protocol*. This protocol covers the destruction of ODS from refrigerant and foam-blowing agents sourced from and destroyed within the U.S.
2. *Livestock Manure (Digesters) Projects Protocol*. This protocol covers capture and destruction of methane from anaerobic manure treatment and/or storage facilities on dairy cattle and swine farms within the U.S.
3. *Urban Forest Projects Protocol*. This protocol covers urban tree planting projects by municipalities, educational campuses, utilities, and partner organizations to sequester carbon within the U.S.
4. *U.S. Forest Projects Protocol*. This protocol covers increasing sequestered carbon or avoided GHG emissions due to forest management activities in three project types: reforestation, improved forest management, and/or avoided conversion within the U.S.

While the regulations contemplate protocols that allow offset projects in North America generally, the current protocols are limited to the United States, and CARB is still evaluating how the four existing protocols can be expanded to include projects in Canada and Mexico. Offset credits from projects located outside of North America may also be used for compliance if they are issued by an outside program that is approved in the future by CARB.

Each protocol approved by CARB, including the above four protocols, must establish a crediting period for the relevant offset project type. The crediting period is the period of time that an offset project is allowed to be issued offset credits. This provides certainty to investors and lenders as to a project's life span. Specifically, the potential for offset credits is protected for the duration of a crediting period even if in the interim the offset project is rendered ineligible to be "additional" due to the subsequent passage of a law or regulation that mandates the activity for which the offset project is designed. At the same time, CARB also seeks the flexibility to update protocols and additionality requirements as merited by developments. To balance these objectives, CARB intends that each protocol for sequestration projects that removes and stores carbon from the atmosphere (such as certain forestry-related offset projects) establish a crediting period between 10 and 30 years and each protocol for non-sequestration projects establish a crediting period between seven and 10 years. After the initial crediting period, a non-sequestration offset project may be renewed twice, and a sequestration offset project may be renewed to the point when the aggregate duration of the crediting periods equals 100 years. In either case, at the time of renewal, an offset project must meet the then-current requirements for additionality and the then-applicable protocol as updated.

The regulations call for project developers to "list" their projects with CARB or an approved offset project registry. Listing is the mechanism for offset project developers to submit information pertaining to the offset project on an ongoing basis in order to meet the requirements needed for the issuance of offset credits. All projects that are listed and the information they submit will be made publicly available on a web site. After CARB or an approved offset project registry has determined that the information submitted is complete and the offset project generally meets the requirements for additionality, it will be listed as a "proposed" project on the web site. It is important to note that the listing process is not intended to be an approval process for offset projects. The determination that an offset project meets all regulatory requirements for issuing offset credits occurs each time that the GHG reductions or removal of an offset project is verified by an accredited verifier. Therefore, it is possible for an offset project to be listed as a proposed project but never achieve the status of an active project or be entitled to receive offset credits.

Ongoing monitoring of offset projects will involve the periodic submission of offset data reports that provide measurement and data collection for key project parameters and review of quality control procedures. Verification is the process of reviewing offset project information to ensure that claimed GHG reductions or removals have been achieved. Once the GHG reductions or removals have been verified by an independent third-party verifier, CARB or an approved offset project registry will confirm that all the requirements have been met and issue offset credits to the offset project in an amount equal to the GHG reductions or removals verified.

Early Action Offset Credits

The regulations also include a process for accepting early action offset credits from existing offset projects under other offset programs. At the outset, if an offset project meets the requirements of the Climate Action Reserve's protocols for ozone-depleting substances, livestock, urban forestry, or forestry (upon which CARB's own protocols are based), then its offset credits will be eligible for use under California's cap and trade program. These early action offset credits will also need to originate from GHG reductions or removals that occur between January 1, 2005 and December 31, 2014 and result from an offset project that commences prior to January 1, 2012. Offset credits from other existing offset programs may qualify for early action treatment in the future following review and approval by CARB.

Sector-Based Offset Credits

The regulations also establish a framework for eventually accepting sector-based offset credits. Sector-based offset credits are generated from GHG emission reductions or removals by a sector-based crediting program that is established by a country, region, or sub-national jurisdiction in a developing country and covering a particular economic sector within that jurisdiction (such as forestry or cement). Reductions or removals of GHG emissions by governmental actions and project activities by private developers in the developing country that in the aggregate fall below a certain crediting baseline would result in offset credits that are eligible for compliance under California's cap and trade program (subject to certain numerical limitations). Each sector-based crediting program will need to be approved by CARB, and likely candidates for future consideration include programs being developed by California's existing partnerships under the Governors' Climate and Forests Task Force and the International Carbon Action Partnership. To that end, the first type of sector-based crediting program for review will likely cover Reducing Emissions from Deforestation and Forest Degradation (REDD).

Limits on Use of Offset Credits

The program allows a maximum of 232 million $MTCO_2e$ of offset credits through the year 2020. This ceiling will be enforced through a limit on the use of offset credits by each covered entity equal to 8 percent of its annual and triennial compliance obligation, respectively.

TRADING AND BANKING OF COMPLIANCE INSTRUMENTS

Market participants may sell or purchase compliance instruments consisting of allowances, offset credits, and sector-based offset credits in the secondary market. Compliance instruments do not expire, which enables covered entities to "bank" and hold compliance instruments until they are needed and other market participants to hold and sell compliance instruments without any deadlines for sale. Information for each trade, including trade date, settlement date, and price, is required to be reported to the accounts administrator of the program. The program also will prohibit any trading activity of compliance instruments that involves an undisclosed counterparty, manipulative or deceptive devices, fraud, reporting of false or misleading information, misrepresentations, or other efforts to falsify or conceal material facts from the market.

The Dodd-Frank Wall Street Reform and Consumer Protection Act establishes an interagency working group, headed by the Commodity Futures Trading Commission, to conduct a study on the oversight of existing and prospective carbon markets, including oversight of the spot markets and derivative markets. The interagency group is required to submit to Congress a report, no later than January 17, 2011, on the results of the study, including recommendations regarding such oversight. Potential market participants in the California cap and trade program should keep track of these developments.

COMPLIANCE AND ENFORCEMENT

CARB has authority under the existing California Health and Safety Code to enjoin and set penalties for violations of its regulations. When a covered entity fails to surrender a sufficient number of compliance instruments by the annual or triennial deadline, the regulations require the covered entity to surrender allowances in an amount equal to four times its excess emissions. If after 30 days the covered entity fails to fulfill this surrender obligation, CARB may take action through its general enforcement authority under the Health and Safety Code.

Monetary penalties can reach $25,000 per violation per day even for negligent violations, while knowing violations will carry more severe penalties, including the possibility of jail time. When calculating monetary penalties under the program, each individual compliance instrument that is not surrendered as required represents a separate violation. CARB also may address any violation of the program by suspending, revoking, or placing transaction restrictions on holding accounts for covered entities, opt-in entities, or voluntarily associated entities, or by suspending or revoking the registrations of other registered participants.

LINKAGE WITH OTHER TRADING PROGRAMS

CARB plans to eventually "link" its cap and trade program for California with similar programs in other jurisdictions to create a broader market. Linkage will involve the reciprocal acceptance of compliance instruments issued by other GHG cap and trade programs. The regulations establish a process by which other programs can be evaluated and approved for linkage by CARB on a case-by-case basis. Sometime in 2011, CARB expects to make specific recommendations for linkage with the programs currently under development by four other WCI jurisdictions: New Mexico, British Columbia, Quebec, and Ontario. CARB also plans to consider linking its program with other programs, including international programs. Linkage recommendations will be made through a formal rulemaking process.

VOLUNTARY RENEWABLE ENERGY ALLOWANCE SET-ASIDE

Under California's cap and trade program, renewable energy that is used for compliance under California's renewable portfolio standard does not convey any GHG reductions. The principal reason is that the GHG reductions resulting from such sale and purchase of renewable energy are already required to be undertaken by state law (*i.e.*, the activity lacks "additionality"). However, the voluntary sale and purchase of renewable energy under a cap and trade program can in fact lead to reductions in GHG emissions that would not have otherwise occurred as long as proper mechanisms are established under the cap and trade program. California has undertaken this step by providing a placeholder in the regulations for a program to set aside and retire allowances in connection with the voluntary sale and purchase of renewable energy. Purchasers of voluntary renewable energy would then be able to make public claims of GHG reductions, and operators of renewable energy projects could potentially receive higher monetary value for selling renewable energy with the ability to make this public claim than they would selling renewable energy without the ability to make this public claim.

PROPOSITION 26

California's cap and trade program still faces future potential challenges. Voters in California recently rejected a ballot measure aimed at prohibiting CARB from implementing AB 32 until the state's unemployment rate falls to 5.5 percent and remains there for a year. Although that measure failed, voters in the same election passed another measure, known as Proposition 26, requiring the California legislature to approve by a two-thirds majority vote any new fee imposed on businesses based on harm to the environment.

It is not clear whether the need to hold compliance instruments under CARB's proposed cap and trade program will trigger the new requirement for legislative approval. CARB has taken the position that Proposition 26 will not impair its ability to enforce any part of AB 32, including a cap and trade program. Depending on how the relevant language is interpreted, Proposition 26 may limit CARB's ability to enforce the program and/or its ability to obtain funding for the program in the future.

PATH FORWARD

CARB has now approved the bulk of California's cap and trade program by adopting the December 16, 2010 resolution. Several key decisions lie ahead, however, as CARB must evaluate the modifications called for by the resolution and fill in a host of other details under the regulations. Certain of the remaining details are clarifying in nature, but others could have a significant effect on the program.

Despite a large number of complex and unresolved issues, CARB plans to move quickly toward implementing the cap and trade program by allowing just 15 days of public comment on any future proposed changes to the regulations. CARB also expects to provide a follow-up report by July 31, 2011 on its progress toward implementing the program and resolving various open items. Entities that may be affected by these new regulations, either on a mandatory or voluntary basis, have no time to spare in developing plans to comply with, or benefit from, California's cap and trade program.

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