JONES DAY

WINTER 2011 ISSUE

THE CLIMATE REPORT

INITIALLY . . .

- **IN 2010, CLIMATE CHANGE STRATEGY SHIFTED FROM COMPREHENSIVE TO PIECEMEAL**

Inability to build consensus doomed efforts, at both the U.S. and international levels, to establish comprehensive climate change regulatory programs in 2010. While greenhouse gas emissions will, particularly in the U.S., be more highly regulated in 2011 than they were in 2010, the immediate future of climate change regulation appears to lie in an assortment of largely uncoordinated regional and piecemeal programs.

On the international level, the United Nations' efforts to broker a global treaty to replace the Kyoto Protocol, which expires in 2012, deadlocked over a fundamental disagreement between developed nations (most notably, the United States) and developing nations (most notably, China). Noting that China has eclipsed the U.S. as the world's largest greenhouse gas emitter and that developing countries will account for two-thirds of global emissions by 2035, developed nations argue that future emission reduction obligations must apply to both groups. However, China and other developing nations argue in response that they should not be required to restrict their economic growth while their per capita GDP still lags far behind those of the developed world.

DEPARTMENTS

As a result, the U.N.'s annual climate treaty summit, held in Cancun, Mexico in December 2010, failed to produce even a framework for a new treaty. As the prospects for achieving unanimity among the more than 190 countries participating in the U.N. process dim, such discussions are increasingly shifting to bilateral and smaller multilateral forums, such as meetings of the G-20 nations.

Comprehensive climate change legislation was equally unsuccessful in the U.S. Congress. Although the House of Representatives narrowly passed the Waxman-Markey bill in 2009, neither that bill nor a Senate alternative made it to the floor of the Senate in 2010. In fact, the Senate's only noteworthy climate change vote in 2010 was on a resolution to bar EPA from regulating greenhouse gases under the Clean Air Act. The measure failed by six votes.

However, as President Obama observed, there is more than "one way of skinning the cat" when it comes to climate change regulation. In contrast to the U.N. stalemate, legislative gridlock in the U.S. did not prevent the executive branch from aggressively pursuing a broad regulatory agenda in 2010 across an array of federal agencies.

Most notably, the U.S. Environmental Protection Agency adopted rules to regulate greenhouse gas emissions from new vehicles, as well as from some new and modified facilities, beginning this month. In December 2010, EPA entered into proposed settlements with a group of states, cities, and environmental groups in which it agreed to finalize in 2012 additional regulations for emissions from new and existing power plants and petroleum refineries. Thousands of U.S. facilities have completed the first year of mandatory greenhouse gas emissions monitoring under a new EPA program, and they are now preparing to submit their first annual reports in March 2011.

The administration's 2010 portfolio of climate change initiatives extended well beyond EPA. For example, the White House Council on Environmental Quality issued draft guidance in February on assessing the climate change impacts of new construction projects under the National Environmental Policy Act. The Department of Energy continued to distribute billions of dollars from the 2009 stimulus bill for a wide range of "clean energy" projects, while the Federal Energy Regulatory Commission moved to implement its Smart Grid Policy and to eliminate transmission-related barriers to wind power and solar energy development. The Securities and Exchange Commission issued interpretive guidance in January on the application of corporate disclosure requirements to climate change issues, and in October the Federal Trade Commission proposed guidance on permissible marketing claims related to renewable energy and "low carbon" products.

Although Congress, particularly one that's gridlocked, has a limited ability to overturn agency actions, the federal courts have jurisdiction to review new regulations for compliance with procedural and substantive law. As EPA promulgated rules in 2010, a wave of challenges—close to 100 separate actions to date—were filed with the U.S. Court of Appeals for the District of Columbia Circuit. Those lawsuits may start to produce judicial opinions in 2011. Moreover, one category of climate change litigation is already on pace to produce a Supreme Court opinion by mid-2011. The Court has agreed to review a Second Circuit holding that common law public nuisance claims may be asserted against greenhouse gas emitters.

Regional climate change initiatives are also poised to take on greater importance in 2011 and beyond. Despite gridlock on a global treaty, the European Union intends to extend and expand its greenhouse gas cap and trade program, including regulation of the aviation industry, which led to a slight increase in EU carbon market prices in 2010. In the U.S., California voters rejected a ballot initiative to delay that state's implementation of a broad cap and trade program, Massachusetts has adopted a plan to reduce greenhouse gas emissions by at least 25 percent by 2020, and the Regional Greenhouse Gas Initiative, a group of northeastern states that already have a cap and trade program for electric utilities, are considering establishing a regional low-carbon fuel standard. However, in contrast to the EU, carbon market prices on U.S. exchanges declined more than 10 percent in 2010.

At the corporate level, climate change—part of the broader issue of environmental sustainability—is increasingly viewed as a matter entitled to senior executive or board level attention. Voluntary disclosure of greenhouse gas emissions information continues to grow, and the investor group Ceres reported a new record in the number of climate

change resolutions submitted by shareholders during the 2010 proxy season. As companies and auditors were digesting the SEC's disclosure guidance, ASTM International finalized its "Standard Guide for Financial Disclosures Attributed to Climate Change," and Standard & Poor's was reportedly working on a methodology for incorporating climate change risks into corporate credit ratings.

Entering 2011, businesses seeking to manage climate change risks face a complex and expanding "patchwork quilt" of regulation under which *what* they emit may be no more significant than *how* and *where* they emit it.

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CALIFORNIA ADOPTS FIRST MANDATORY, ECONOMY-WIDE CAP AND TRADE PROGRAM

On December 16, 2010, the California Air Resources Board ("CARB") approved a resolution ordering its Executive Officer to finalize, with certain changes, the greenhouse gas cap and trade regulations proposed by CARB on October 29, 2010. Once published, CARB will allow 15 days for public comment on the latest changes, and the Executive Officer will respond to any such comments, make any other "conforming" modifications deemed appropriate, and then finalize the cap and trade regulations.

California's cap and trade program will serve as a U.S. test case for mandatory, economy-wide greenhouse gas market systems. Existing market-based programs, like the Regional Greenhouse Gas Initiative and the Climate Action Reserve, are either voluntary in nature or mandatory only for certain economic sectors. California's program, however, represents the first cap and trade program for greenhouse gas emissions that is mandatory for numerous sectors of the economy.

Although CARB has now approved the bulk of the cap and trade program, several key decisions lie ahead. The Executive Officer must evaluate the modifications called for by the resolution and fill in a host of other details for the program. Some of these remaining details will have a significant effect on the program. For example, CARB has yet to propose a full methodology for distributing emissions allowances to electric utilities. For other industrial sectors, CARB still must develop energy efficiency benchmarks that will influence emissions allowance allocations to those sectors. There are also uncertainties surrounding the development of domestic offset protocols, linkage to international offset programs, and full linkage with programs in other jurisdictions.

CARB plans to issue a follow-up report on a large portion of the open issues, including a final allowance allocation system, no later than July 31, 2011, and intends to move quickly to implement the program. Entities that may be affected by

the new cap and trade program, either as mandatory covered entities or voluntary participants, have little time to spare in developing plans to comply with, or benefit from, the program.

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California's cap and trade program is discussed in further detail in the Jones Day White Paper*, "California Adopts Cap and Trade Program for Greenhouse Gas Emissions," available at www.jonesday.com/california__adopts__cap__and__trade.*

FERC SEEKS COMMENT ON PROPOSALS TO IMPROVE WIND AND SOLAR INTERCONNECTIVITY

The Federal Energy Regulatory Commission continued efforts to connect wind and solar generation facilities to the interstate grid by issuing a Notice of Proposed Rulemaking on Integration of Variable Energy Resources.

FERC seeks comments by January 31, 2011 on three proposals. First, FERC proposes to provide transmission customers with the option of using more frequent transmission scheduling intervals within each operating hour. Traditionally, resources are scheduled on an hourly basis; the proposal would allow customers to adjust schedules at 15-minute intervals, enabling variable energy resources and transmission providers to better manage variations from wind and solar facilities. Second, FERC proposes to require interconnection customers with wind-based and solar-based variable energy resources to provide transmission providers with site-specific meteorological data. Third, FERC proposes establishing a new generic rate schedule through which transmission providers may recover the costs of holding unloaded resources in reserve to respond to real-time variations attributable to variable energy resources.

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U.S. EPA PROPOSES GREENHOUSE GAS PERMITTING GUIDANCE

Under EPA's May 2010 "Tailoring Rule," greenhouse gas emissions from the largest industrial sources became subject to the Clean Air Act's "prevention of significant deterioration," or "PSD," preconstruction permit program and the Act's Title V operating permit program on January 2, 2011. With the PSD program applicable to greenhouse gas emissions, federal, state, and local permitting authorities must now determine what constitutes the "best available control technology," or "BACT," for such emissions.

On November 10, 2010, U.S. EPA issued draft guidance to assist permit writers in making such determinations. In its proposed guidance, EPA makes clear that it is not changing its established "top-down" process for selecting BACT on a case-by-case basis for greenhouse gas emissions. Rather, EPA stresses that permit writers have discretion to determine BACT for greenhouse gases using the same five-step process it has recommended in the past for other types of emissions. These steps are: (1) identify all available control technologies; (2) eliminate technically infeasible options; (3) evaluate and rank remaining control technologies; (4) evaluate cost effectiveness of controls and energy and other environmental impacts; and (5) select BACT.

Throughout its discussion of these five steps, EPA emphasizes energy-efficiency as a primary consideration in any greenhouse gas BACT analysis. In particular, EPA states that "BACT for a new combustion source should include the consideration of methods that increase the overall energy efficiency of the source. In general, a more energy efficient technology burns less fuel than a less energy efficient technology on a per unit of output basis." The draft guidance also identifies carbon capture and sequestration ("CCS") as a technology that should be considered an "available technology" for new large combustion sources, although EPA is skeptical that CCS will ultimately be selected as BACT due to its limited commercial availability and high cost.

EPA also provided industry-specific information on the sectors that emit the highest amounts of greenhouse gases in several white papers that the Agency issued in connection with its BACT guidance. These white papers summarize available control measures to reduce greenhouse gases from electric generating units ("EGUs"), large industrial/commercial boilers, the pulp and paper industry, the portland cement industry, the iron and steel industry, petroleum refineries, and nitric acid plants.

While the white papers provide information for use in making BACT determinations, they do not prescribe BACT for any of the covered industries. EPA's EGU white paper, for example, states that there is "no one best available coal-fired EGU technology universally applicable to all EGU projects." EPA defines an EGU as a solid fuel-fired steam generating unit that serves a generator that produces electricity for sale to the electric grid. Carbon dioxide is identified as the primary greenhouse gas emitted by EGUs. According to EPA, the primary factors affecting carbon dioxide emissions are the type of coal burned, the overall efficiency of the power generation process, and the use of air pollution control devices.

EPA discusses options for increasing energy efficiencies on EGUs, along with the benefits and drawbacks of numerous technologies for carbon dioxide control, including CCS, use of supercritical and ultra-supercritical boilers, coal drying, and oxygen combustion. Although bituminous coal is identified as the type of coal with the lowest carbon dioxide emissions per unit of heat input, EPA does not believe that requiring EGUs to exclusively use this type of coal would necessarily reduce overall greenhouse gas emissions, in light of the methane (another greenhouse gas) released during mining and other releases associated with mining, processing, and transporting coal.

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(For additional details on the requirements of the Tailoring Rule, see the Jones Day White Paper*, "Climate Change Regulation Via the Clean Air Act: EPA's New Greenhouse Gas Rule for Facilities," available at www.jonesday.com/climate_change_regulation, or the Jones Day Webcasts, "EPA's New Greenhouse Gas Rule for Facilities: Climate Change Regulation Via the Clean Air Act," available at www.jonesday.com/epas-new-greenhouse-gas-rule-for-facilities-climate-change-regulation-via-the-clean-air-act-05-19-2010, and "Beyond Cap and Trade: Climate Change Regulation Under the Clean Air Act Arrives," available at www.brighttalk.com/webcast/23677.*

FERC CLARIFIES RULING ON CALIFORNIA'S CHP REGULATIONS

On October 21, 2010, the Federal Energy Regulatory Commission clarified a prior ruling on California's Waste Heat and Carbon Emissions Reduction Act, Assembly Bill (AB) 1613, a decision that had threatened to derail California's efforts to set a feed-in tariff for electricity from combined heat and power ("CHP") generating facilities. FERC previously found that federal law did not preempt the California Public Utility Commission's ("CPUC") proposed regulations, but only to the extent that the CHP generators were "qualifying facilities" and the rates imposed by California did not exceed the "avoided costs" of the purchasing utility. Avoided costs are the incremental costs that an electric utility would pay, but for the purchase from the qualifying facility.

CPUC sought clarification. First, CPUC wanted assurance that it could require retail utilities to consider different factors in the avoided cost calculation in order to promote the development of more efficient CHP facilities. Second, CPUC wanted clarification that "full avoided cost" did not need to be the lowest possible avoided cost.

In its clarification order, FERC confirmed that a multi-tiered avoided cost rate structure could be consistent with the avoided cost rate requirements set forth in federal law. FERC further clarified that in establishing the avoided cost rate, CPUC could take into account obligations imposed by the

state, such as those requiring utilities to buy energy from particular sources of energy or for a long duration. While FERC stressed that it was not ruling on whether the rates established by CPUC would satisfy the avoided cost rate requirement, the clarification establishes a stable basis from which CPUC can implement a CHP feed-in tariff.

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CLIMATE CHANGE ISSUES FOR MANAGEMENT

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S&P AIMS TO ADD CLIMATE CHANGE RISK ANALYSIS TO CREDIT RATING PROCESS

According to an October 21, 2010 article in the Bureau of National Affairs' *Daily Environment Report*, climate-related performance may soon be factored into credit ratings of carbon-intensive companies. Based on comments by Standard & Poor's United Kingdom-based head of global carbon markets, the article reports that S&P is working on ways to integrate carbon risk analysis into its corporate credit rating system and hopes to prepare a methodology by early 2011.

S&P said the methodology would then be subject to "a rigorous criteria process review." The article highlights that developing the methodology will be "fiendishly complex" due to the need to consider direct emissions generated by a company, indirect emissions associated with the company's activities (*e.g.*, use of electricity, supply chain, and transportation), and the ability to pass along carbon costs to customers.

S&P identified only one example to date of a company's credit rating being downgraded on the basis of greenhouse gas liabilities—a coal-fired generator in the UK reportedly downgraded in May 2009. Although S&P's head of global carbon markets expects there will be more downgrades based on carbon risk going forward, he did not expect the carbon risk methodology to result in immediate, wholesale downgrades of credit ratings.

S&P indicated that the impetus to include carbon risk in credit ratings has come from such developments as the proposed tightening of the European Union's emissions trading scheme in its third phase, beginning in 2012. Accordingly, companies with a substantial EU footprint may face more clearly defined climate-related liabilities, but the S&P carbon risk methodology may apply to non-EU companies as well. S&P indicated that a global rollout for the carbon risk methodology could begin as early as the first half of 2011.

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2010 CARBON DISCLOSURE PROJECT REPORT FINDS THAT S&P 500 LAGS GLOBAL 500 IN CARBON PERFORMANCE

Perhaps the most well-known source of data used by credit rating agencies, investors, and others to evaluate companies' climate-related performance is the set of reports compiled annually by the Carbon Disclosure Project ("CDP") from responses to CDP's climate change questionnaire. According to CDP, 534 financial institutions with assets of more than $64 trillion were signatories to the CDP 2010 information request, which was sent to more than 4,700 of the world's largest companies.

CDP's September 2010 report on the S&P 500 summarized responses from 70 percent of the S&P 500 companies (up from 66 percent in 2009), detailing climate change risks and benefits, including how they plan to capitalize on commercial opportunities related to climate change. In addition, 59 percent of the S&P 500 companies (up from 52 percent in 2009) disclosed their carbon emissions, at least in part.

The 2010 CDP report notes that the demand for CDP's carbon performance data continues to grow and is now accessed through Bloomberg and Google Finance. The report includes a new performance score evaluating leadership in managing carbon risk and exposures, and asserts that large U.S. companies lag behind the Global 500 peer group, in which three times as many companies score high enough to be recognized as carbon performance leaders.

CDP has also launched two index products designed to identify companies well-positioned for a transition to a low carbon economy—the FTSE CDP Carbon Strategy Index series and the Markit Carbon Disclosure Leadership Index.

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CERES REPORT ASSERTS WATER SCARCITY IS A "HIDDEN" RISK FOR UTILITY BOND INVESTORS

The perceived need for credit agencies to incorporate climate risk into credit ratings was further reflected in an October 2010 joint report by Ceres, an investor advocacy group, and Water Asset Management, a global equity investor in public and private water-related companies and assets, entitled "The Ripple Effect: Water Risk in the Municipal Bond Market." The report concludes that growing water scarcity in many regions of the United States, allegedly due to long-term climatic changes, persistent drought, and other factors, is an underreported risk running through municipal bond markets.

The report states that more than 80 percent of the United States' residential and industrial consumers rely on public water utilities that collectlively issue billions of dollars of bonds each year to fund infrastructure for continued water delivery. Similarly, public power utilities have a smaller but significant portion of the nation's power grid, delivering electricity to 45 million people. The power sector is extremely water-intensive and reportedly accounts for 41 percent of the nation's freshwater withdrawals.

To assess water risks, the report includes a qualitative model, developed by PricewaterhouseCoopers LLP, to evaluate utilities' water scarcity risk exposure by comparing available supplies with projected water demand for the next 20 years. After applying the model to eight investment-grade public utility bonds, the report concludes that credit ratings of municipal bonds failed to take into account the utilities' vulnerability to water scarcity.

For example, the Ceres report asserts that credit rating agencies failed to account for the Los Angeles Department of Water & Power's high water risk due to environmental regulations, prolonged drought, and reliance on vulnerable water supplies, such as the Colorado River. In addition, the report concludes that rating agencies ignored water risk in municipal bonds for Atlanta's Water & Sewer System arising from reliance on one key water supply, whose future is jeopardized by a judicial order that may require the city to dramatically reduce its withdrawals by as much as 40 percent in 2012.

After determining that credit rating methodologies reward utility pricing and infrastructure plans that encourage increased water use and revenue growth while allegedly disregarding water scarcity issues, Ceres recommends that credit rating agencies employ water risk "stress tests" in water utility ratings, factor water intensity into ratings for electric utilities, and award higher ratings to utilities that manage water demand through pricing incentives in anticipation of future supply constraints. Ceres further recommends that utilities provide more robust disclosure of water risks for climatic changes, persistent drought, legal conflicts, and environmental regulation, and recommends that investors demand increased disclosure of these risks.

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U.S. EPA ELIMINATING VOLUNTARY "CLIMATE LEADERS" PROGRAM

On September 15, 2010, U.S. EPA sent a letter to its Climate Leaders industry partners informing them that it will wind down the Climate Leaders program over the next year. Since 2002, the Climate Leaders program has assisted some of the nation's largest companies in voluntarily determining their carbon footprint, establishing emission reduction goals, sharing best practices, and receiving public recognition for their efforts.

In its letter, EPA said it "has determined that climate programs operated by the states and NGOs are now robust enough to service our Partners and other entities that wish to continue to advance their climate leadership through comprehensive reporting (that exceed mandatory reporting requirements) and/or the establishment of facility or corporate-level [greenhouse gas] reduction goals." Another factor is EPA's shifting focus from voluntary climate change efforts, such as Climate Leaders, to implementation of the Agency's new mandatory greenhouse gas reporting program.

At a meeting in October 2010 with industry partners to discuss the phase-out of Climate Leaders, company representatives reportedly expressed disappointment with and surprise at EPA's decision, since the program was generally viewed as an overall success by those that participated. Some company officials questioned whether the move represents a philosophical shift away from use of the "carrot" of voluntary cooperation, leaving only the regulatory enforcement "stick."

As the program winds down over the next year, EPA intends to "encourage and assist the transition of our Partners into non-federal programs that our Partners choose to join." Alternatives include the Carbon Disclosure Project, which collects greenhouse gas emissions data from many of the world's largest companies each year, and The Climate Registry, which is a voluntary multistate initiative extending into Canada. Asserting that it intends to continue to promote climate leadership efforts, EPA said it will "pursue a jointly sponsored recognition program with one or more NGOs to allow our Partners and other climate leaders to continue to be acknowledged for their greenhouse gas reductions."

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CARBON MARKET TRANSACTIONS

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EUROPEAN UNION EMISSIONS TRADING SCHEME CHALLENGED BY AIRLINES

The European Union's extension of its emissions trading scheme, known as "EU-ETS," to the aviation sector holds significant financial implications for aircraft operators and aerospace suppliers. Requirements for carbon allowances under the regulations will be implemented in January 2012, while other aspects of the regulations (such as reporting) are already in place. Because the EU-ETS aviation regulations effectively span the globe by covering certain emissions of foreign-registered aircraft outside of EU airspace, they have been controversial from the start.

It is therefore hardly surprising that three U.S. airlines and the U.S. airline industry's principal trade association, the Air Transport Association of America, contested the application of the EU-ETS regulations to airlines outside the EU. Their lawsuit was originally filed with the United Kingdom's High Court, as the UK is administering the regulations applicable to the airline claimants. The challenge will ultimately be heard, however, by the EU Court of Justice, and the parties and interveners recently submitted written observations to that court.

The challenged regulations have two essential components. First, they cap total emissions allowances for all flights that "depart from or arrive in an aerodrome situated in a Member State," without regard to flight time or amount of emissions in EU airspace. Second, they obligate airlines to obtain and surrender emissions allowances equal to their emissions in the preceding calendar year, again without considering flight time or emissions in EU airspace. Thus, the regulations implicate the entirety of flights that arrive in or depart from EU member states, not just the portion of those flights within EU airspace.

As with other businesses covered by the EU-ETS, airline operators whose emissions exceed their allocated allowances will be required to purchase extra allowances from the carbon market. The number of allowances initially given to the aviation sector is a variable percentage of the industry's average annual emissions from 2004 to 2006. In 2012, this percentage will be 97 percent. The number of allowances allocated to an airline for 2012 will be based on its proportionate share of the total attributed aviation emissions in 2010. In 2012, 85 percent of allowances will be issued for free. Because the aggregate emissions allocated in the first year will reflect a three percent overall reduction, airlines that do not reduce their emissions by 17 percent must obtain surplus allowances.

The airlines argue that the aviation-related EU-ETS regulations violate long-established principles of international law, breach international obligations requiring a consensual resolution within the framework of the U.N.-chartered International Civil Aviation Organisation ("ICAO"), and contravene the Chicago Convention and EC-US Open Skies Agreement. The claimants further contend that applying the scheme to emissions outside of EU airspace breaches sovereignty laws applicable to aviation, and that the collection of carbon allowances violates a Chicago Convention rule limiting aviation charges to cost-based recovery.

The defendant, the UK Secretary of State for Energy and Climate Change, opposes the substantive grounds advanced by the airlines but did not oppose the EU Court of Justice hearing the dispute, given the considerable international significance of the issues, the complex and relatively immature interrelationship between international and EU law, and the fact that most non-EU governments have questioned the legality of applying the EU-ETS to airlines based outside the EU.

Represented by Jones Day, the International Air Transport Association ("IATA") and the National Airlines Council of Canada ("NACC") have intervened and argue that the extension of the EU-ETS to international aviation emissions is simply an attempt by the EU to impose its will on other nations regarding a common global issue, climate change. Noting that such unilateral action will damage the regime of aviation law long founded on cooperative principles of mutuality, accommodation, and sovereign noninterference embedded in customary international law, IATA and NACC also contend that the regulations would inhibit the development of environmental law and multilateral solutions to potential

environmental threats. In addition, IATA and NACC argue that regulation of aircraft emissions in this manner ignores the role of the ICAO, which was given exclusive responsibility by the Kyoto Protocol for reducing greenhouse gas emissions from the international aviation sector.

Other EU member states may file comments, but which countries chose to do so will not be known until all written submissions to the EU Court of Justice are released in 2011. Thereafter, an oral hearing will be conducted by the court and the court's Advocate General. Several weeks after the oral hearing, the Advocate General will deliver an opinion containing a legal analysis and suggestion for how the court should rule. The judges will then deliberate, a process that often takes several months. The parties have requested priority handling of the dispute, in an effort to resolve the issue before the 2012 implementation date, but that decision is committed to the discretion of the court's president.

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CALIFORNIA POISED TO EMBRACE TRADABLE RENEWABLE ENERGY CREDITS

California's Renewables Portfolio Standard ("RPS") program promotes the development and use of renewable energy by requiring the state's load-serving entities to meet a targeted percent of their load obligations with energy generated from renewable resources. The California Public Utilities Commission ("CPUC") is responsible for ensuring that California's load-serving entities meet their RPS targets. Historically, the CPUC has only permitted use of "bundled" renewable energy credits ("RECs"), meaning RECs transferred with renewable energy delivered to California load, for RPS compliance.

Transition to a Bundled and Tradable REC Compliance Regime. In March 2010, the CUPC issued a decision that authorized California's load-serving entities to also procure and use "tradable" RECs, meaning RECs unbundled from the underlying renewable energy, to meet their RPS compliance obligations. The CPUC stayed its decision shortly after it was issued, amid petitions from California's largest investor-owned utilities and independent power producers asking the CPUC to scale back some of the restrictions the decision imposed on the use of tradable RECs. The CPUC is scheduled to address its tradable REC policies at its January 13, 2011 open meeting, and based on alternative proposals that have been circulated in the proceeding, the CPUC may implement the substance of the March 2010 decision, subject to a few clarifications or modifications.

Once the CPUC acts, parties will be able to use tradable RECs to help meet their RPS obligations, although in the first few years of implementation, the CPUC will treat bundled RECs and tradable RECs as slightly different RPS compliance mechanisms. For example, California's three largest investor-owned utilities will be permitted to use only tradable RECs for up to 25 or 30 percent of their RPS compliance obligations until the end of 2011 and possibly longer. Also, all investor-owned utilities will be subject to a $50 price cap on tradable RECs for some initial period.

In addition, load-serving entities will have limited ability to "earmark" tradable RECs to help them avoid penalties for failing to satisfy their RPS compliance requirements. Earmarking allows an RPS-obligated entity to designate RECs that will be produced and delivered in a future year to make up shortfalls in RPS procurement for the current compliance year. Bundled RECs will remain eligible for earmarking. In many other respects, however, bundled RECs and tradable RECs will be treated interchangeably for RPS compliance purposes.

Producing and Using Bundled and Tradable RECs. Parties interested in producing or acquiring bundled RECs will have to establish that the generator from which the RECs are produced is delivering its energy to a California balancing authority. To do so, the generator can either interconnect to the Western Electricity Coordinating Counsel transmission system in a California balancing authority area, or dynamically transfer its energy to a California balancing authority through dynamic scheduling or a pseudo tie arrangement. The CPUC may also recognize firm transmission arrangements as another method for verifying that energy is delivered to California load, but it has not yet developed this approach.

Meanwhile, tradable RECs will be obtainable through almost any other REC transaction or contract. An entity will be able to acquire tradable RECs through transactions that expressly convey RECs and not energy, or through transactions that convey both energy and RECs, but where the energy associated with the RECs does not serve California load.

Of course, tradable RECs, like bundled RECs, will only be useful for RPS compliance if they meet other RPS requirements. For example, the facility producing the RECs must meet the California Energy Commission's RPS-eligibility and certification requirements. It also must register with the Western Renewable Energy Generation Information System, and the RECs it produces must be tracked in that system. Any generator located in the Western Electricity Coordinating Counsel transmission system will be able to produce tradable RECs, provided it meets the other RPS requirements. All RECs, whether bundled or tradable, will be available for RPS compliance only if used within three years of production.

The CPUC's decision on tradable RECs, expected in early 2011, will provide parties with more flexibility to meet their RPS targets and, importantly, create longer-term incentives for the development of renewable generation projects both inside California and in the western U.S. In the near term, however, parties should expect that once the CPUC votes to allow the use of tradable RECs, California's demand for this type of REC will exceed supply and that most available tradable RECs will come from short-term deals with existing RPS-eligible facilities.

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U.S. EPA DELAYS OBLIGATION TO REPORT POTENTIALLY SENSITIVE GREENHOUSE GAS DATA

On December 27, 2010, U.S. EPA proposed to defer until March 31, 2014 a requirement under the Greenhouse Gas Reporting Program, codified at 40 C.F.R. Part 98, to report certain data that are inputs to emission equations—including production and throughput quantities, product compositions, raw materials used, and other process-specific information—for calendar years 2010, 2011, and 2012. The purpose of the reporting deferral is to allow EPA time to evaluate the potential business impact from the disclosure of that data before it is collected by EPA and then potentially subject to public availability. To allow time to finalize the proposed rule, EPA also issued an interim final rule that extends the deadline for reporting emission input data for calendar year 2010 (currently March 31, 2011) to August 31, 2011.

The proposed rule applies only to facilities covered by Subparts C through JJ and Subparts RR, SS, and TT of the Program, and not to suppliers of fuels and industrial greenhouse gases. It also does not affect the reporting of any other data, including emissions totals, which still must be reported for calendar year 2010 by March 31, 2011 using EPA's Electronic Greenhouse Gas Reporting Tool.

It is also important to note that the proposed rule only defers reporting of the emission equation inputs. Facilities must still collect the information and maintain records of all inputs to emission equations in a form that is suitable for expeditious inspection and review.

Unless EPA decides to substantively change the Program's reporting obligations, facilities must report all inputs for 2010, 2011, and 2012 by March 31, 2014. To that end, EPA issued a call for information requesting information from the public on the potential impact of disclosure of the emissions input data, including how public availability could cause competitive harm, whether any of the data elements are already publicly available through other data sources, and alternative

methods for calculating greenhouse gas emissions or conducting verification of reported data.

Public comments on the proposed deferral rule may be submitted to EPA through January 26, 2011, and all responses to the call for information must be submitted by February 25, 2011.

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U.S. EPA ADDS REQUIREMENTS FOR CARBON SEQUESTRATION FACILITIES

U.S. EPA has imposed new requirements on facilities where carbon dioxide is injected and sequestered underground. On December 1, 2010, EPA finalized a rule subjecting carbon sequestration operations to its Greenhouse Gas Reporting Program, which will require such facilities to report basic information on carbon dioxide received for injection and the amount of carbon sequestered at the site; develop and implement a site-specific monitoring, reporting, and verification plan; and conduct annual monitoring activities. The rule does not require covered facilities to report carbon dioxide emissions from the facilities. Affected sources must submit their first annual report to EPA by March 31, 2012.

On December 10, 2010, EPA published final rules establishing requirements to ensure the safety of underground injection of carbon dioxide and to prevent injected gas from contaminating groundwater. The rules, adopted under the Safe Drinking Water Act, require site characterization to ensure injection wells are located in areas where carbon dioxide can be safely sequestered, and establish requirements for well construction (such as including automatic shutoff systems), testing, and monitoring. Additionally, the rules expand financial responsibility requirements designed to ensure that well operators have sufficient funds for emergency or remedial actions, well closure, and post-injection site care. States may apply until September 6, 2011 for primary responsibility to implement the new rules.

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MARKET FOR CARBON ALLOWANCES REMAINS ANEMIC

At the close of trading on December 27, 2010, prices for a credit representing one metric ton of carbon dioxide equivalent emissions in December 2011 were as follows:

MARKET	PRICE
EU Emissions Trading Scheme	€14.09
CDM Certified Emission Reductions	€11.23
Regional Greenhouse Gas Initiative (RGGI)	$1.91
California Climate Action Registry	$2.38
Retail Offsets—Climate Care	$12.22

A combination of factors—the lack of a mandatory nationwide cap and trade system in the United States, the ongoing economic recession, and emission reduction goals that have been achievable without the need for allowances or offsets—continue to depress the price of carbon allowances.

Decreasing demand resulted in the announcement in October that the Chicago Climate Exchange, known as CCX, would end its program for trading greenhouse gas emission allowances at the end of 2010 and become solely a registry for offset emission credits. CCX was launched in 2003 as a voluntary "pilot" carbon emission trading market for carbon emission allowances, called Carbon Financial Instruments, each of which represented the elimination of one metric ton of greenhouse gas emissions.

The market value of CCX carbon allowances peaked in the fall of 2008 at approximately $7 per ton, but by the fall of 2009, the allowances had dropped to approximately 10 cents per ton. By fall 2010, the allowances were virtually worthless and trades were becoming few and far between. In August 2010, no allowances were traded and only 10,200 tons were sold in September. Without viable buyers, the cost of running the exchange was no longer warranted. CCX's registry and

trading services will, however, remain available through the middle of 2011 for existing emission allowance contracts. With its new focus exclusively on offset projects, CCX plans a new offset registry program in 2011 and 2012, which will include a publicly available registry and a transfer mechanism to process trades.

The economic climate has also affected the RGGI. Only 57 percent of the carbon allowances offered for sale during RGGI's most recent auction on December 1, 2010 were sold for the minimum reserve price of $1.86. The previous auction, in September 2010, sold only 75 percent of available allowances. Decreasing allowance prices over the past several RGGI auctions have been attributed to decreased electricity demand, utilities' increased use of alternative fuels such as natural gas, and utilities' increased use of alternative technologies, such as nuclear, wind, and hydroelectric power.

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U.S. EPA TO CLARIFY THE STATUS OF BIOMASS ENERGY

Although U.S. EPA recently issued guidance for regulators drafting Clean Air Act permits for greenhouse gas emitters, one issue that remains unclear is the status of biomass and biogenic emissions. EPA has announced that it plans to issue guidance in January 2011 on the environmental, energy, and economic benefits that may be attributed to the use of biomass, with further guidance to come in May 2011 on whether carbon dioxide emissions that result from the combustion of biomass must be controlled at new and modified stationary sources.

Biomass is biological material, most commonly plant matter such as wood chips, switchgrass, or corn, that is utilized to generate electricity or produce heat as a renewable energy source. EPA has stated that it does not have sufficient information to determine whether biomass emissions are carbon-neutral, and thus could be excluded from consideration in applying greenhouse gas permitting requirements. It solicited additional public comments, resulting in more than 7,000 submissions on this issue.

Proponents of biomass argue that such emissions should not be considered in applying the regulatory threshold, because burning plants simply returns to the atmosphere carbon dioxide that the plants removed as they grew, in contrast to burning fossil fuels, which results in emission of carbon that had been sequestered below ground for millennia. Opponents argue that the biomass cycle is not entirely carbon-neutral and does not adequately account for the effects of land-use changes.

EPA's guidance in the first part of 2011 should clarify two issues: (1) whether a stationary source's emissions from biomass combustion must be included in calculations to determine whether that source exceeds applicable permitting thresholds, and (2) whether "fuel-switching" from fossil fuels to biomass may be selected as the "best available control technology" in greenhouse gas emissions permits.

In the meantime, the U.S. Department of Agriculture is moving forward with plans to provide financial assistance under the Biomass Crop Assistance Program to farmers who grow commercial biomass crops, such as switchgrass, sorghum, hybrid poplars, and willows. Under the final rule, published October 27, 2010, 50 million acres of existing pasture land and traditional cropland would be converted to biomass energy production. The USDA believes that this broad program is necessary to meet the federal renewable fuel standard, which requires production of 36 billion gallons of renewable fuel, including fuel from biomass, by 2022.

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CLIMATE CHANGE LITIGATION

Kevin P. Holewinski, Editor

SUPREME COURT WILL HEAR APPEAL ADDRESSING USE OF PUBLIC NUISANCE SUITS AGAINST GREENHOUSE GAS EMITTERS

The U.S. Supreme Court recently announced that it will decide whether the common law doctrine of public nuisance can be applied to greenhouse gas emissions. The Court on December 6, 2010 granted certiorari and announced that it will hear a challenge to a decision by the U.S. Court of Appeals for the Second Circuit allowing a public nuisance lawsuit against American Electric Power Co. and other utilities based on their greenhouse gas emissions. *American Electric Power Co. v. Connecticut*, U.S., No. 10-174.

The Second Circuit decision allowed Connecticut, seven other states, New York City, and three environmental groups to proceed with lawsuits against AEP, the Tennessee Valley Authority, and other utilities that alleged the power companies' greenhouse gas emissions constituted a nuisance under federal common law. *Connecticut v. American Electric Power Co.*, 582 F.3d 309 (2d Cir. 2009). The U.S. District Court for the Southern District of New York had dismissed the lawsuit in 2005, holding that the claims were nonjusticiable under the political question doctrine and thus not within the jurisdiction of the courts. *Connecticut v. American Electric Power Co.*, 406 F. Supp. 2d 265, 268 (S.D.N.Y.).

The Supreme Court granted certiorari without limitation, meaning the Court will hear all three questions presented in the petition: i) whether the plaintiffs have standing to seek judicially fashioned emission caps on five utilities for their alleged contribution to harms claimed to arise from global climate change caused by more than a century of emissions by billions of independent sources; ii) whether a cause of action to cap greenhouse gas emissions can be implied under federal law, where no statute creates such a cause of action, and the Clean Air Act speaks directly to the same subject matter and assigns federal responsibility for regulating such emissions to U.S. EPA; and iii) whether claims seeking to cap defendants' emissions at "reasonable" levels based on a court's weighing of the potential risks of climate change against the socioeconomic utility of the defendants' conduct are nonjusticiable under the political question doctrine.

According to the Court, Justice Sonia Sotomayor, who was a member of the Second Circuit when that court heard oral arguments in *Connecticut v. American Electric Power Co.*, took no part in the certiorari decision. Briefing is due to be complete by April 11, 2011. No date has yet been set for oral argument, but a decision is expected before the court's summer recess.

Separately, on January 10, 2011, the Supreme Court denied a petition for a writ of mandamus in *Comer v. Murphy Oil*, where a class of Mississippi property owners asked the Court to order the U.S. Court of Appeals for the Fifth Circuit to hear their appeal in a climate change tort lawsuit. *In re: Comer*, U.S., No. 10-294.

In *Comer*, a three-judge panel of the Fifth Circuit in October 2009 overturned a lower-court decision, holding that the property owners could proceed in federal court with their tort lawsuit, in which they alleged that a group of energy and other companies should be held liable under Mississippi common law for property damage caused by Hurricane Katrina, based on the defendants' greenhouse gas emissions. On the motion of the defendant energy companies, a majority of the full Fifth Circuit voted to vacate the three-judge panel's decision and rehear the matter *en banc*.

However, on May 28, 2010, the Fifth Circuit issued an order written by five of its judges dismissing the appeal, holding that the court could no longer give the lawsuit full court review, because one of the nine judges who had agreed to grant *en banc* review of the panel's decision had since recused himself. Three judges dissented. *Comer v. Murphy Oil USA*, 607 F.3d 1049 (5th Cir. 2010).

(Jones Day is counsel of record for Xcel Energy Inc. in the *Connecticut* and *Comer* cases.)

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INDUSTRY CHALLENGES U.S. EPA'S PARTIAL CLEAN AIR ACT WAIVER FOR E15 GASOLINE

On November 4, 2010, U.S. EPA partially granted ethanol producers' request for a Clean Air Act waiver allowing use of gasoline containing up to 15 percent ethanol by volume, known as "E15." While the application sought a waiver for use of E15 across the board, EPA granted the waiver only with respect to model year 2007 and newer light-duty motor vehicles, because those vehicles have more sophisticated emissions control systems. In addition, EPA's testing showed that when used with E15, emissions deterioration rates over the useful life of the vehicles were not significantly different than when used with gasoline containing no ethanol. EPA rejected the waiver with regard to model year 2000 and older light-duty motor vehicles, heavy-duty motor vehicles, motorcycles, and non-road products, because such vehicles and products have less sophisticated emissions control systems that may not meet emissions standards if used with E15.

On November 9, 2010, various food, restaurant, meat, and petroleum associations filed a petition for review in the U.S. Court of Appeals for the District of Columbia Circuit. *Grocery Mfrs. Ass'n v. U.S. Envtl. Prot. Agency*, No. 10-1380 (D.C. Cir.). The petitioners argue that the waiver is premature, because the testing is insufficient to show that use of E15 will not cause or contribute to the failure of emissions control devices, and that EPA lacks statutory authority to grant the partial waiver.

Growth Energy, the ethanol producers' trade association that applied for the E15 waiver, has moved to intervene in partial support of EPA, stating that while it "reserves the right to challenge certain aspects of the EPA's waiver decision, it has a direct and substantial interest in defending the grant of a waiver and the EPA's authority to grant a waiver in the circumstances of this case." Motion of Growth Energy for Leave to Intervene at 4, *Grocery Mfrs. Ass'n v. U.S. Envtl. Prot. Agency*, No. 10-1380 (D.C. Cir. Dec. 6, 2010). The industry petitioners do not oppose the motion, and EPA has indicated that it will take no position.

Two more challenges to the waiver have been filed recently: *Alliance of Automobile Manufacturers v. EPA*, No. 10-1414 (D.C. Cir.), and *Petrochemical & Refiners Assn. v. EPA*, No 11-1002 (D.C. Cir.). Procedural motions are due January 14, 2011, and dispositive motions are due January 28, 2011.

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TEXAS CHALLENGES U.S. EPA'S WITHDRAWAL OF STATE'S GREENHOUSE GAS PERMITTING AUTHORITY

The ongoing dispute between Texas and U.S. EPA over EPA's assertion of authority to regulate greenhouse gas emissions under the Clean Air Act resulted in two recent decisions from federal Courts of Appeal, one temporarily favorable to Texas, the other temporarily favorable for EPA.

On December 30, 2010, in response to an emergency motion filed by Texas the same day, the U.S. Court of Appeals for the D.C. Circuit issued a temporary stay that blocked EPA from taking over greenhouse gas permitting authority for sources in Texas, pending further action by that court. The day before, the U.S. Court of Appeals for the Fifth Circuit had declined to issue a stay that would have delayed EPA's plans as Texas' lawsuit against the federal agency moved forward.

Texas' motions arose out of its broader ongoing dispute with EPA over that agency's efforts to regulate greenhouse gas emissions under the Clean Air Act, including EPA's most recent efforts, announced on December 23, 2010, to take over greenhouse gas permitting under the Act's Prevention of Significant Deterioration program in those states whose air laws are not as stringent as EPA's May 2010 "Tailoring Rule." Texas is one of a group of states that have filed challenges to the Tailoring Rule, which took effect on January 2, 2010, in the D.C. Circuit. However, Texas is the only state that has refused to either amend state permitting law to implement the requirements of the Tailoring Rule or agree that EPA may issue permits for greenhouse gas emissions while the legal challenges to the Tailoring Rule proceed.

In its *per curiam* order, the D.C. Circuit noted that the order issuing the stay "should not be construed in any way as a ruling on the merits" of Texas' motion. The United States filed its response brief on January 6, 2011, and Texas filed its reply on January 7, 2011.

An EPA motion to dismiss or, in the alternative, transfer Texas' Fifth Circuit challenge to the D.C. Circuit remains pending before the Fifth Circuit.

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CLIMATE CHANGE REGULATION BEYOND THE U.S.

Chris Papanicolaou, Editor

U.N. TALKS IN CANCUN MARK STEPS TOWARD GLOBAL EMISSIONS LIMITATIONS OR REDUCTION TARGETS, BUT MANY ISSUES REMAIN

One year after the Copenhagen Accord, many commentators believe credibility has been restored to international climate change negotiations following the United Nations' annual climate change conference, which ended on December 11, 2010 in Cancun, Mexico. Two texts of agreement (known as the Cancun Agreement) were adopted by representatives of 194 nations at the 16th Conference of the Parties, or "COP 16," to the U.N.'s Framework Convention on Climate Change. The ultimate goal is to arrive at a global climate change treaty to succeed the Kyoto Protocol, which expires at the end of 2012.

Despite repeated objections from Bolivia, agreement was reached on a number of individual issues. The parties agreed on an objective that greenhouse gas emissions should peak and that a goal should be set to limit average global temperature rises to 2 degrees Celsius (compared to pre-industrial levels). The agreements call for a review of this goal, and a possible tightening, starting in 2013. A goal of reducing global greenhouse gas emissions by 25 percent to 40 percent compared to 1990 levels by 2020 was set, and the need for countries to "raise the level of the emissions reductions" to achieve those goals was recognized. Details as to how this will be achieved were not, however, covered.

The agreements included much-discussed "transparency measures" for developing nations to report their greenhouse gas emissions and to have their actions to curb emissions verified every two years. Many states consider this issue a bedrock element of any new global climate change agreement.

Agreement was also reached on the creation of a legal framework for a Green Fund, which had been agreed to in principle in 2009 at COP 15 in Copenhagen, to raise and disburse $100 billion a year to assist poor countries with low-carbon

development and to help the most vulnerable adapt to rising sea levels and other climate impacts. Wealthy nations reiterated their 2009 pledges to provide $30 billion of fast-track financial aid for 2010–12.

The Kyoto Protocol's Clean Development Mechanism ("CDM"), which governs voluntary emission reduction projects in developing countries, will see important changes, including the introduction of standardized baselines for assessing emission reductions, as an alternative to project-by-project assessment. The main objective is to enable the CDM process to produce more carbon credits without unnecessary, and accordingly costly, delay. In addition, the parties agreed to include carbon capture and storage projects in the CDM, provided that certain standards are established, including a future procedure for selecting and monitoring carbon storage sites, mandatory risk and safety assessments, and clear assignment of liability for such sites.

Broad agreement was also reached on creating carbon credits through projects to avoid deforestation under the framework known as Reducing Emissions from Deforestation and Degradation, or "REDD." Deforestation is believed to account for about 20 percent of global greenhouse gas emissions.

Despite talk of the Cancun Agreement being a new step forward, many key issues remain unresolved, and there was no consensus on how to move the framework of the Kyoto Protocol forward. With nations such as Japan, Canada, and Australia unwilling to commit without specific reduction commitments from the United States and major developing countries, such as China, time is running out to finalize, and then ratify, an agreement for a post-2012 emission reduction commitment period.

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CHINA PROVIDES OPPORTUNITIES TO GENERATE CARBON CREDITS VIA THE CDM PROCESS

Although China is a signatory to the Kyoto Protocol, it is listed as a "non-Annex I" country, meaning it is not under any legal obligation to reduce its greenhouse gas emissions. However, under the Protocol's Clean Development Mechanism, foreign entities either from or sponsored by an Annex I signatory can partner with non-Annex I countries, such as China, to carry out voluntary projects that reduce greenhouse gas emissions in those countries, yielding carbon credits, known as certified emission reduction units, or "CERs." Foreign entities can also acquire CERs generated through such CDM projects and use them to satisfy their home country's greenhouse gas reduction commitments.

CDM projects must follow the procedures under the Kyoto Protocol, Marrakesh Accords (U.N. Doc. FCCC/CP/2001/13/Add.2 Jan. 32, 2002), and the Montreal Accord (U.N. Doc. FCCC/CP/2005/8/Add.1 Mar. 30, 2006). Such projects must further the host country's sustainable development and produce greenhouse gas emission reductions that are additional to what would occur in the absence of the proposed activity.

A Major Source of CDM Opportunities. China is an attractive site for CDM projects, because Chinese projects generally offer the greatest carbon reductions for the least investment, and it is relatively easy to demonstrate "additionality." According to U.N. statistics, CDM projects in China constitute 41.79 percent of all registered projects and have produced 252,324,614 CERs, representing 52.92 percent of all CERs issued.

In 2010, China released its "Emerging Energy Industry Development Plan," which calls for an investment of RMB 5 trillion over the next 10 years, providing for investments in the clean technology and renewable energy sectors, along with measures for upgrading and transforming conventional energy sources. China has also established a CDM fund that reinvests money generated from its CDM projects in other domestic climate change initiatives.

China's CDM Approval Process. CDM projects in China are regulated by the Measures for the Operation and Management of Clean Development Mechanism Projects in China (Order No. 37 [2005], effective Oct. 12, 2005). Under these CDM Measures, CDM projects in China must be owned either by a wholly Chinese-funded enterprises or one in which at least 51 percent of the equity is controlled by a Chinese party. However, the CDM Measures permit foreign

entities to acquire the CER credits generated through CDM projects in China.

Under the Kyoto Protocol, all proposed CDM projects must by approved by the host country's Designated National Authority, which in China is the National Development and Reform Commission ("NDRC"). The CDM application to the NDRC must include a floor price for the CERs that are to be generated during the life of the project. If this floor price is below the applicable minimum floor price, which is set by the NDRC and varies by project, the application will likely be rejected.

Upon acceptance by the NDRC, the application will be submitted for expert review, before consideration by the National CDM Board, which is made up of members from the NDRC, the Ministry of Science and Technology, the Ministry of Foreign Affairs, and various other ministries. Based on the Board's recommendation, the NDRC will then approve the CDM application and issue the project owner a letter of approval.

Next, the project owner must have its Project Design Document approved by a Designated Operational Entity, an independent auditor accredited by the U.N.'s CDM Executive Board, and have the project registered at the Executive Board. As the CDM project is implemented, the Designated Operational Entity will verify monitoring results, certify the exact amount of greenhouse gas emission reductions resulting from the project, and report the results to the Executive Board.

The owner of the CDM project and the foreign entity that is purchasing the CERs generated through the project should have in place an Emissions Reduction Purchase Agreement or similar arrangement. As the Designated Operational Entity reports the project's verified emission reductions to the CDM Executive Board, the Executive Board will, upon request, cause CERs to be issued to the registry accounts of the foreign entity. Under the CDM Measures, the Chinese government is entitled to collect from the project owner a "CER transfer benefit," ranging from 2 percent to 65 percent of the revenue from the transfer.

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