

US House Adopts First-of-its-Kind Bill Combining Climate Change Cap-and-Trade with a Comprehensive Energy Program

After only a few hours of general debate and consideration of only two amendments, the US House of Representatives agreed on June 25, 2009 to approve H.R. 2454, the “American Clean Energy and Security Act of 2009” (ACESA), otherwise known as the “Waxman-Markey” bill. Attesting to the fine balance negotiated by House leaders, the final tally was 219-212, with 211 Democrats and eight Republicans voting “yes,” and 168 Republicans and 44 Democrats voting “no.” It now goes to the Senate where it awaits an uncertain future.

While the ACESA is the third major energy bill to pass the House in this decade, it is the first time that either chamber of Congress has passed a bill that would require large sources of greenhouse gases (GHGs) in multiple US economic sectors to reduce their emissions. At the same time, the bill is meant to shift the United States towards renewable energy and thereby drive the US economy away from fossil fuels. To achieve these results, the ACESA would amend the Clean Air Act (CAA), several energy statutes, market regulation statutes, and agriculture laws, while creating major new laws. In sum, at 1,427 pages, the ACESA is a lengthy, complex, and comprehensive bill that would bring about major changes for a broad range of businesses.

Remarkably, H.R. 2454 advanced through the House with breathtaking speed, beginning with its introduction on May 15, its being voted 33-25 out of the House Energy and Commerce Committee (E&C Committee) on May 21, and then final House passage on June 25. For more information about the earlier progress of the bill, please see our May 29, 2009, Client Alert, “US House Energy and Commerce Committee Adopts Comprehensive Energy and Climate Bill,”¹ and our

June 12, 2009, Client Alert, “US Congressional Committee Releases Report on Wide-Ranging Energy and Climate Bill.”²

Climate Change Program

CAP-AND-TRADE SYSTEM

To control GHG emissions, the ACESA would add two new titles to the CAA. Initially, carbon dioxide (CO₂), methane, nitrous oxide, sulfur hexafluoride, hydrofluorocarbons (emitted from a chemical manufacturing process), any perfluorocarbon, and nitrogen trifluoride would be designated as GHGs. Different GHGs have different capacities to trap heat and different atmospheric lives, so consistent with the usual practice, comparisons would be made by converting emissions of any particular gas to an amount of carbon dioxide that would have the equivalent effect on climate.

Large sources would report their GHG emissions each year, and emissions levels would be capped. The sources subject to the cap, referred to in the ACESA as “covered entities,” would include, among others: electric utilities (including cooperatives and municipalities); producers and importers of fuel, the combustion of which would emit 25,000 tons or more of carbon dioxide equivalent; natural gas distributors supplying 460 million cubic feet of gas to customers that are not covered entities; sources producing 25,000 tons of carbon dioxide equivalent or more of bulk industrial gases; stationary sources producing cement, primary aluminum, or lime; a variety of chemical and petrochemical sources; petroleum refiners; and stationary sources emitting 25,000 or more tons of carbon dioxide equivalent that produce iron and steel, ferroalloys, glass, zinc, or pulp and paper.

As in the version of the bill adopted in May by the E&C Committee, US GHG emissions would be capped relative to 2005 levels such that there would need to be a 3% reduction in 2012, a 17% reduction in 2020, a 42% reduction in 2030, and a 83% reduction in 2050. Use of a 2005 baseline is a substantial departure from the Kyoto Protocol, which requires reductions relative to 1990 emissions.

Each year the Environmental Protection Agency (EPA) would distribute a specific number of emission allowances. The allowances would represent a limited authorization to emit one metric ton of GHG on a carbon dioxide equivalent basis. To comply with the applicable emissions cap, a covered entity could reduce its emissions, acquire the number of allowances matching its emissions level either from EPA or from “trades” with other persons, or acquire offset credits (discussed below). Failure to “hold” the necessary quantity of allowances on April 1 of the calendar year following the year of emission would be a violation of the CAA subject to significant penalties. For covered entities that are subject to the existing operating permit program under Title V of the CAA, the GHG requirements would be implemented through permits issued and enforced in accordance with those provisions.

In the early years of the program, EPA would distribute most allowances to covered entities free of charge, but it is important to keep in mind that each entity would not receive the same proportion or number of allowances. The percentage of free allowances to be distributed to various sectors was a major part of the negotiations leading to passage of the bill in the E&C Committee and in the House. In later years, EPA would distribute the allowances through an annual auction. Whether by trade or auction, the allowances could be acquired not only by emitting sources but also by environmental organizations and other non-emitters. Anyone could retire allowances, potentially affecting the overall supply.

In addition, allowances would be distributed directly to a variety of non-emitters to promote various policies such as preventing deforestation in developing countries. US states would receive allowances to support their natural resources climate change adaptation activities and to help residential and commercial consumers of oilheat fuel, propane, and

kerosene. Non-emitters presumably would sell their allowances and use the proceeds for these programs.

The cap-and-trade system would begin gradually, with the start date depending on the economic sector. For electric utilities, the system would start in 2012, while 2014 would be the starting year for covered industrial sources. For natural gas distributors, the start year is 2016, and they would need to hold allowances equivalent to the emissions resulting from all the fuel they sell to users other than downstream utilities/industrials.

COST CONTAINMENT

The ACESA contains several measures intended to help covered entities bear the costs of complying with the cap. Chief among these is allowing an entity to cover a portion of its emissions with “offset credits.” In total, up to 2 billion tons per year of such credits could be available, with 50% of those coming from US projects and 50% from international projects. If the domestic supply is not sufficient, EPA could allow use of up to 1.5 billion tons per year of international offset credits. One domestic offset credit, or 1.25 international offset credits, could be held in lieu of an emission allowance.

Offset credits would be generated by projects that reduce, avoid, or sequester GHG emissions, and that are in addition to what otherwise would occur. The US Department of Agriculture (USDA) (for domestic farm and forestry projects) and EPA (for other projects, including international offsets) would identify the types of projects eligible for credits. Regulations would, among other things, define “additionality,” account for leakage (i.e., moving GHG emissions from one point to another, such as may occur if a forest management project at one location leads to other forested areas being cleared), account for reversals (such as may occur if a fire or insect infestation destroys a forest that was being managed to sequester carbon), and specify methods for quantifying and verifying offsets.

As another cost containment measure, the ACESA would require EPA to establish within two years of enactment a “strategic reserve,” which would hold part of each year’s allocated emission allowances. For 2012-2019, 1% of the allowances would be placed in

the reserve, with the percentage growing to 2% for 2020-2029, and 3% for 2030-2050. Each year EPA could auction a portion of the reserve (5% for 2012-2016, 10% thereafter) at a minimum price to covered entities expected to need them for compliance purposes.

The price would start at \$28 per ton (in 2009 dollars) for 2012 and increase over time. The auction proceeds would be deposited in a strategic reserve fund and spent, without being subject to annual appropriation, to buy international offset credits issued for reduced deforestation activities in developing countries. EPA then would retire those credits, and deposit into the reserve the number of emission allowances equal to 80% of the retired credits.

UNCAPPED EMISSION SOURCES

Within 12 months of enactment, EPA would publish an inventory of stationary source categories that individually emit more than 10,000 tons per year of CO₂ equivalent and that, taken together, account for 20% or more of uncapped GHGs, but that are not subject to the ACESA cap-and-trade program. EPA then would establish standards of performance for the inventoried sources pursuant to the CAA's new source performance provisions.

APPLICABILITY OF THE CLEAN AIR ACT

The ACESA's GHG provisions are largely structured as amendments to the CAA. But while certain CAA provisions would apply fully to the GHG requirements, or even be expanded, others would not.

For example, the ACESA would require EPA to issue numerous rules, often with brief and overlapping deadlines. EPA would be subject to the CAA's rulemaking procedures, and the final rules subject to the CAA's judicial review provisions. More importantly, the cap-and-trade program and all other GHG requirements of the new CAA titles would be enforceable under the CAA. EPA thus would be able to use all its existing information-gathering and enforcement powers in connection with GHGs. Further, the ACESA would expressly amend the CAA's citizen suit section to apply to "any requirement" of the new GHG provisions, instead of restricting citizen suits to specifically identified requirements as in the existing CAA.

At the same time, the ACESA would preclude listing any GHG under the CAA's National Ambient Air Quality Standards program because of "its effect on global climate change." The CAA's international air pollution provisions likewise would not apply to an "air pollutant" based on its "contribution to global warming," which neither the ACESA nor the CAA defines. No GHG could be added to the CAA's list of air toxics except where it meets the applicable criteria for such listing "independent of its effects on global climate change." New source review provisions would not apply to GHG emissions from a "major emitting facility" that is "initially permitted or modified" after January 1, 2009. Such exemptions may lessen, but seem unlikely to eliminate, concerns about the reach and scope of the CAA's command and control regulations with respect to GHG emissions.

Title VI of the CAA would be amended to provide for a phase down in the consumption of hydrofluorocarbons (HFCs) produced in the United States, imported into the United States in bulk, or contained in products or equipment such as appliances. The baseline would be set using data from 2004-2006; consumption and imports would decline each year from 90% of the baseline in 2012 to 15% of the baseline in 2032.

From 2012-2017, the ACESA would preclude states and their political subdivisions from implementing or enforcing a cap-and-trade system on emissions capped by CAA titles; however, limits or targets on GHGs implemented by means other than emission allowances would not be preempted. The ACESA thus provides only limited preemption, but it does appear to sweep in the "RGGI" program, a cap-and-trade system for power plants that is being implemented individually, but cooperatively, by 10 northeastern states. After 2017, the CAA's existing provisions that allow states and their political subdivisions to adopt more stringent air pollutant requirements would apply to GHGs caps, allowances, and offset credits.

PREVENTION OF CARBON LEAKAGE

To prevent GHG sources from moving overseas to avoid emissions reductions, the ACESA would create an emission allowance rebate program for entities in eligible domestic manufacturing sectors within North

American Industrial Classification System (NAICS) Codes 31, 32, and 33, or that process metal ores, including iron and copper ores, soda ash, or phosphate. Based on specified criteria, EPA periodically would promulgate rules (beginning in 2011) specifying the eligible industrial sectors and the rebate amounts. The rebates then would be distributed annually from an allowance pool set aside for trade-vulnerable industries.

Also included in the ACESA is a finding that leakage can be addressed “most effectively” by negotiated agreements between the United States and foreign countries, as well as a policy statement calling for the United States to work under the UN Framework Convention on Climate Change for “binding agreements, including sectoral agreements,” that commit all “major” emitting countries to “contribute equitably” to reducing GHG emissions. The President of the United States would notify foreign countries of the above policy statement, include a “declaration” requesting them to take “measures” to limit their GHG emissions, and point out that in 2020 “international reserve requirements” could apply to a “covered good” of the country.

The President also would report to Congress by January 1, 2017 on the “effectiveness” of the rebates in “mitigating carbon leakage in eligible industrial sectors.” If an appropriate multilateral agreement has not entered into force by January 1, 2018, the President must establish an international reserve allowance program for “each eligible industrial sector” applicable to “covered goods” of an eligible industrial sector that enter into the United States after January 1, 2020. In other words, importers could need to acquire allowances for covered goods. Such a program would not need to be established, however, if the President determines and certifies to Congress that it would not be in the economic or environmental interest of the United States, and if Congress agreed by an enacted joint resolution. The ACESA also creates an exception from the international allowance requirements when 85% of US imports are produced in countries that meet GHG or energy intensity requirements, or that are parties to certain emission reduction agreements. President Obama has expressed reservations about these provisions.

AGRICULTURE

Although the US agricultural sector is not subject to the cap-and-trade program, it may have won the largest number of concessions in the post-E&C Committee negotiations. Chief among these is giving USDA, rather than EPA, authority over domestic farm and forest offset projects and credits. The ACESA also would specify the minimum list of domestic agricultural and forestry practices eligible to generate offset credits. Included are tillage practices, winter cover cropping, dietary management practices for animals, afforestation, urban tree planting, and manure management. Emission allowances also would be made available directly to the Secretary of Agriculture for promoting activities in the agriculture sector that reduce GHGs or sequester carbon.

Aside from limiting EPA’s role on farming and forestry offsets, the bill would restrict EPA from adding any indirect emissions from international land use changes to calculations of GHG emissions from US biofuel production when it sets its renewable fuels standard. Moreover, a portion of the emission allowances would be allocated to rural electrical cooperatives.

CARBON MARKETS

Through an amendment to the Federal Power Act, the Federal Energy Regulatory Commission (FERC) would have the responsibility of issuing regulations within 18 months of the ACESA’s enactment that govern markets for the new emission allowances, offset credits, and federal renewable electricity credits. The regulations would cover market oversight, fraud, market manipulation, excess speculation, limits on “unreasonable fluctuation in the prices” of such allowances, market transparency, and otherwise preserve market integrity. FERC would have new enforcement powers, including cease-and-desist authority, and would establish and collect “transaction fees” to recover costs to the government.

In addition, the ACESA would amend the Commodity Exchange Act to give the Commodity Futures Trading Commission (CFTC) authority to, among other things, regulate carbon and energy derivatives transactions.

Energy Provisions

GENERAL

While not receiving as much attention as the cap-and-trade program, the energy provisions of the ACESA are just as extensive and comprehensive. Among other things, the bill would:

- Require the development of a national carbon capture-and-sequestration (CCS) strategy addressing key legal, regulatory, and other barriers to commercial-scale deployment;
- Provide for the establishment by industry referendum of a Carbon Storage Research Corporation to accelerate CCS technologies and methods;
- Amend the Public Utility Regulatory Policies Act to provide electric utility plans for infrastructure to support plug-in electric drive vehicles;
- Direct the Secretary of Energy to establish a program to deploy and integrate plug-in vehicles into the electricity grid in multiple regions;
- Provide financial aid to automakers for the retooling of facilities for the manufacture of plug-in vehicles or batteries for plug-in vehicles that are developed and produced in the United States;
- Revise the CAA definition of renewable biomass;
- Provide for the distribution of CAA emission allowances annually from 2011 through 2049 to states for renewable energy and efficiency programs to be administered through the State Energy and Environment Accounts;
- Amend the Federal Power Act regarding transmission planning and siting and construction of a transmission facility in the western United States;
- Give FERC a greater role in transmission planning by requiring adoption of grid planning principles and coordination of regional planning;
- Limit the federal backstop siting law under the Power Act to interstate lines or interstate segments of intrastate lines in the eastern interconnection;
- Set detailed energy efficiency standards for lighting and appliances; and
- Require the development of energy efficiency building codes that are more efficient than existing industry standards. If state and local governments

fail to enforce those codes, the Secretary of Energy would do so and would define the federally enforceable code violations through rulemaking.

RENEWABLES/EFFICIENCY

Perhaps the single most important energy component of the ACESA is its combined efficiency and renewable electricity standard that would begin at 6% in 2012 and increase to 20% by 2021 for retail suppliers that sell more than 4 million megawatt hours per year of electricity to consumers. One-quarter of this requirement could be achieved through efficiency, but a state governor could petition FERC to increase that to two-fifths.

Here, too, agriculture benefited. The definition of biomass that could be used to generate qualifying renewable electricity would be broadened. In an arrangement that seems likely to have been crafted to include biodigesters, which are capable of being used in many farming operations, “distributed renewable generation facilities” would be assured of receiving for at least 10 years three renewable electricity credits for each megawatt hour of renewable electricity generated.

Other Provisions

The ACESA is so massive at 1,427 double-spaced pages, and so much horse-trading appears to have taken place, that it is commonly being described as having something for everyone, and yet there still is room for disappointment. Several environmental groups are grumbling that the requirements have been watered down too much, but the bill does now direct EPA to regulate black carbon (i.e., soot), unless it decides existing CAA regulations are sufficient. For business, it requires the President to consider intellectual property protections in determining the eligibility of developing countries to receive allowances (thereby providing financing for their GHG reductions). For labor, recipients of “emission allowances or funding” would provide assurances that all laborers and mechanics on projects funded by the federal government under the ACESA, or by “any entity established in accordance with the ACESA or its amendments, including the Carbon Storage Research Corporation,” will be paid at not less than the prevailing local wage rate in accordance with the Davis-Bacon Act.

Other provisions added to the bill after it was voted out of the E&C Committee would:

- Require EPA and other agencies to report to Congress on the contribution of natural gas vehicles to reduce GHGs and on ways to maximize that contribution;
- Require the Secretaries of Energy and of Commerce to make recommendations on new federal lending authority for renewable energy in US areas not served by the federal power marketing authority;
- Establish a program in the US Department of Housing and Urban Development (HUD) to support local building code enforcement of fire, safety, electrical, plumbing and other codes, including energy efficiency codes; and
- Direct HUD by rule to prohibit private covenants that restrict or prohibit installation of solar systems.

If enacted, the ACESA would require extensive agency activity, often on short deadlines. The result would likely be a severe strain on agency resources. Further, many of the ACESA's new provisions and programs are not funded by emission allowances, but are subject to appropriations, which, in the current budgetary atmosphere, could make it difficult to fund them fully or at all.

Next Steps

Legislative activity now switches to the Senate, where President Obama is expecting "tough" negotiations. Environmentalists generally believe a stronger bill is needed, especially with respect to GHG emissions; GHG emitters are looking for their own improvements; some supporters of the House bill do not believe that any significant changes can be made without upsetting the deals that already have been struck.

Six different Senate committees will be working on legislation to match the Waxman-Markey ACESA bill. While the ACESA bill is the likely first template,

everything is thought to be on the table. Even Rep. Waxman has indicated that he is open to any significant changes if they are needed to get a bill through the Senate. The Environment and Public Works Committee has held general hearings, but the Chair reportedly does not plan to mark up legislation until September. The Senate Committee on Energy and Natural Resources already has ordered reported energy legislation that covers many of the issues in the ACESA. The Senate Majority Leader has indicated that he plans to bring that energy bill and a climate bill to the floor.

Apparently, the Senate is currently working towards a September 28 deadline and a possible floor vote this fall, with a goal of having legislation on the President's desk before this December's UN climate negotiations in Copenhagen. While the Democrats now have 60 Senators to achieve cloture, climate change still is unlikely to be addressed in the Senate along strict party lines. Economics and regional issues will play a substantial role in determining whether and when a bill moves forward.

Endnotes

¹ Available at <http://www.mayerbrown.com/climatechange/article.asp?id=6847&nid=10445>.

² Available at <http://www.mayerbrown.com/climatechange/article.asp?id=6967&nid=10445>.

For more information about the ACESA, or any other matter raised in this Client Update, please contact any of the following lawyers.

David B. Finnegan

+1 202 263 3301

dffinnegan@mayerbrown.com

Roger W. Patrick

+1 202 263 3343

rpatrick@mayerbrown.com

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