

TRAJECTORY OF U.S. FEDERAL CAP AND TRADE LEGISLATION UNDER THE OBAMA ADMINISTRATION

On January 20, 2009, the United States will have, for the first time, a President who has committed to enacting a national cap and trade program and other mandatory measures to reduce greenhouse gases (“GHGs”) in the U.S. The Obama administration could table a framework for a climate change plan, along with further legislative proposals from the U.S. Congress in the first months of the 2009. This bulletin identifies some key initiatives and drivers to watch in the U.S. as the new administration takes over.

Why Obama’s plan matters to Canadians:

U.S. federal energy and climate policy under the new Obama administration is of interest to Canadian business for several reasons:

- *Market opportunities and challenges:* New incentives and market opportunities may be available to Canadian companies in the U.S. Also, Canadian companies with American operations will be subject to new U.S. federal climate laws and will have to adjust their business and legal strategies accordingly.
- *Potential North American GHG regulations:* Canada may follow a U.S. cap and trade model for GHG emissions or eventually fall under a North American scheme. The Canadian government has publicly expressed its interest in developing a North American cap and trade system. Minister of the Environment Jim Prentice told attendees of the Lake Louise World Cup Business Forum in November that Canada must “forge an immediate relationship with the new American administration in order to quickly and collectively address the environmental issues that straddle the borders of our two nations.”



Davis LLP’s **Climate Change practice group** includes lawyers with a wide variety of Canadian and international experience ranging from regulatory compliance to project finance. Our national team helps clients navigate the evolving world of climate change regulation and seize opportunities in an increasingly carbon-constrained economy. We also have expertise in areas of renewable energy including wind energy, run of river hydro, biomass and fuel cell industries.

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Why Obama's plan matters (continued):

- *Trade implications:* U.S. federal plans could include carbon tariffs in the form of border tax adjustments or emissions allowance purchase duties on energy or carbon intensive imports. Anticipating these potential trade issues, Canada's federal government has teamed Minister Prentice up with Lawrence Cannon, Minister of International Relations, and Stockwell Day, Minister of International Trade to work with the U.S. on the negotiation of a North American system.
- *Trajectory of post-Kyoto international negotiations:* U.S. federal climate policy will likely have a significant impact on the trajectory of UN negotiations for a new international climate treaty following Kyoto, which, in turn, will likely have an impact on Canadian domestic policy. President-elect Obama has expressed his interest in re-engagement with the UN, which would represent a marked departure from the Bush administration's refusal to ratify the Kyoto Protocol.

What are President-elect Obama's Plans for a federal cap and trade program?

President-elect Obama has said that his administration would prioritize a federal cap and trade system for GHGs that would reduce U.S. emissions to 1990 levels by 2020 and reduce GHG emissions by 80% by 2050. Although he has not provided many details on such a plan, he has called for a system that would auction 100% of allowances at the outset the program.

Obama has announced Lisa Jackson as the head of the U.S. Environmental Protection Agency ("EPA") – the agency that would have authority over a GHG cap and trade program. Jackson is the former commissioner of New Jersey's Department of Environment and was reportedly instrumental in securing New Jersey's participation in the Regional Greenhouse Gas Initiative ("RGGI"). Carol Brower, who will coordinate energy and climate

polices and the activities of the EPA and the Department of Energy under Obama, implemented the first national cap and trade program to reduce sulphur dioxide emissions in the U.S.

How soon will the U.S. pass a federal cap and trade law?

It is difficult to say when cap and trade legislation will be adopted and implemented in the U.S., or to be certain that the ultimate U.S. federal policy will, in fact, include a cap and trade program. Clearly the economic and financial crisis will be the first priority of the new U.S. administration. While the Obama administration has committed to a national cap and trade program and Congress has been busy developing proposals for such a system since 2007, the economic crisis will likely postpone the adoption of such legislation. Still, Obama has told reporters as recently as December 2008 that "the time for delay is over" and that climate change "is a matter of urgency and national security, and it has to be dealt with in a serious way." There are a number of political drivers that could keep climate change on the front burner in 2009.

First, there is pressure from the U.S. courts to regulate GHGs in the U.S. The U.S. EPA has been effectively directed by the U.S. Supreme Court under *Massachusetts v. EPA* to regulate GHG emissions under the *Clean Air Act*. At the same time, the *Clean Air Act* is widely perceived to be an inadequate legislative framework for regulating GHGs since it would likely mean regulations based on best available technology controls rather than the more flexible cap and trade system. There is therefore an incentive to establish cap and trade legislation to head-off court-ordered GHG regulations under the *Clean Air Act*. The Obama administration has indicated it would revert to the *Clean Air Act* approach clarified by the U.S. Supreme Court if Congress has not produced cap and trade legislation in 18 months.

Second, U.S. states and regional initiatives will likely continue to fill any vacuum on climate policy. Since Obama was elected, California has moved ahead and adopted a ‘Scoping Plan’ to implement its 2006 *Global Warming Solutions Act* (“AB 32”), and most states and provinces appear on track to begin reporting activity under the Western Climate Initiative as early as 2011 based on 2010 emissions. States in RGGI have recently announced plans to expand their cap and trade program beyond carbon dioxide emissions in the power sector. If these regional initiatives continue to surge ahead, industry actors and some less ambitious states may, in turn, push the U.S. federal government to enact an economy-wide system to avert a patchwork of regulatory frameworks.

Third, there will be some pressure on the Obama administration to have concrete proposals on the table for United Nation negotiations in Copenhagen in December 2009. The Conference of the Parties 15 (“COP 15”) of the UN Framework Convention on Climate Change (“UNFCCC”) will meet in Copenhagen at the end the year to negotiate a new agreement to take effect once the first commitment period of the Kyoto Protocol expires in 2012. Although the U.S. has not ratified the Kyoto Protocol, the new U.S. administration is widely anticipated to re-engage the UN climate talks. The U.S. is particularly concerned with ensuring large, emerging-economy emitters like China and India begin to reduce GHG emissions. Obama has said his administration will “engage vigorously” with the UNFCCC and indicated he would establish a “Global Energy Forum” that would include G8 countries plus China, India, Mexico, Brazil and South Africa.

Although Congress will not likely be pressured to agree to domestic legislation before Copenhagen 2009, the Obama administration will likely push for some agreed domestic principles with which it can base its cooperation on GHG reductions with the international community – particularly emerging economies.

What is the status of GHG Cap and Trade Bills in the U.S. Congress?

There are a number of bills in the U.S. Senate and House that would establish an economy-wide GHG cap and trade program. Since 2007 the Congress has introduced ten cap and trade proposals, which are summarized in the table at the end of this bulletin. These proposals tend to include mandatory caps that decline over time and penalties for non-compliance. Differences include the following:

- *Scope*: Some proposals cover all major sectors while others cover only the power sector;
- *Offset provisions*: Some allow partial compliance through domestic or international offsets while others do not;
- *Allocations*: Some call for immediate allowance auctioning while others call for a gradual introduction of auctions; and
- *International harmonization*: Some proposals include incentives and penalties for action or non-action by other countries and some proposals do not.

The proposals that have received most attention are the Boxer-Lieberman-Warner *Climate Security Act* and the Dingell-Boucher “Discussion Draft”.

Senate Proposals

Proposals to establish a comprehensive GHG cap and trade programs emerged initially from the Senate. In 2003 Senators Lieberman and McCain introduced the *Climate Stewardship Act*, which set out to reduce emissions to 2000 levels by 2012 in electricity, transport and industrial and commercial facilities. The leading Senate proposal is the *Climate Security Act* (“CSA”), introduced by Senators Lieberman and Warner in 2007 and amended by Environment and Public Works Committee chair, Boxer. The CSA was the first congressional cap and trade bill to pass out of committee to the Senate floor for wider consideration, but the bill failed to gain the

sufficient support required for further consideration.

The original Lieberman-Warner bill with Boxer's amendment contemplated a 4% cut in GHG emissions below 2005 levels in 2012, followed by a 19% cut in 2020 and 71% cut in 2050. Emissions allowances would have been given away to start and auctioned at an increasing rate. The bill ambitiously identified allocations of emissions allowances for the entire period to 2050. The CSA also required allowances for energy intensive imports from countries determined by an appointed commission not to be undertaking "comparable" action to reduce emissions.

Boxer, who remains chairman of the Senate Environment and Public Works Committee continues to take the lead role in developing the Senate's version of a national cap and trade bill and has committed to produce a "more streamline version" of the CSA. Boxer plans to introduce a new bill early in the New Year and has cited California's AB 32 as a model for such legislation. She has also indicated that her proposal, unlike the earlier-drafted CSA, will include a significant delegation of power to the U.S. EPA to develop rules for the system.

Background: Lawmaking in the U.S. Congress

The U.S. Congress has sole power to pass federal laws in the U.S. and is divided into two chambers, the 100-member Senate and the 435-member House of Representatives. The Senate and the House work in parallel to develop legislative proposals. After a proposal is submitted in the Senate or House, it is referred to one or more committees with jurisdiction over the bill's subject. The major committees with jurisdiction over climate change policy are the Environment and Public Works Committee in the Senate and the Energy and Commerce Committee in the House. The chairs of the relevant committees, who are always members of the majority party, decide whether or not the committee will consider proposals. From there, the committees forward the bill to the entire House or Senate respectively, where House or Senate leader decides whether the bill will be read. The bill then goes to a joint House-Senate conference for compromise drafting, is voted on in each house, and ultimately goes to the President for final approval.

House proposals

Four proposals for national climate change legislation have emerged from the House of Representatives, although none have passed onto the House floor out of the Energy and Commerce Committee.

In October 2008 Congressman Dingell, Chair of the Energy and Commerce Committee and Congressman Boucher, Chair of the Energy and Air Quality Subcommittee released a "Discussion Draft" for a national cap and trade bill, which has been widely anticipated to serve as a point of departure for legislative drafting in 2009. Nevertheless, following elections in 2008, Congressman Henry Waxman unseated Dingell for the chairmanship of the Energy and Commerce Committee, putting into question, to some extent, the focus on the Dingell-Boucher proposal for House discussions over climate policy in 2009. Dingell, from Michigan, was chair of the committee for 28 years. Waxman, from California, led one of the House proposals in 2007 (the *Safe Climate Act*).

The Dingell-Boucher proposal covers 88% of GHG emissions in the U.S. and requires a 6% reduction below 2005 levels by 2020, 44% below 2005 levels by 2030 and 80% below 2005 levels by 2050 and would regulate GHG emissions from sources that release more than 25,000 tons of GHGs per year – the same threshold as the Western Climate Initiative proposal that involves British Columbia, Manitoba, Ontario and Quebec. The discussion draft sets out different options for allowance auctioning and grandfathering for the power and industrial sectors. Regulated facilities could use an increasing number of offsets over the course of the program for compliance. From 2013-2017 domestic or international offset credits could be used to collectively satisfy up to 5% of an installation's compliance obligation and from 2018-2020, 15%.

The Dingell-Boucher proposal also discusses an "International Climate Change Commission" that would assess, by 2013, which U.S. trading partners have taken "comparable action to limit greenhouse gas emissions".

“Covered” countries that have not taken comparable action to the U.S. would be required to submit “international reserve allowances” to

compensate for the GHG emissions associated with the production of the products they export to the United States.

Summary of economy-wide cap and trade proposals in the Senate and House

Bill	Introduced	Key Details
Proposals in the Senate		
Boxer-Lieberman-Warner <i>Climate Security Act of 2008</i>	June 2008	<ul style="list-style-type: none"> • first target: 4% below 2005 levels by 2012 • increasing auction of allowances • 30% limit on offsets
Bingaman-Specter <i>Low Carbon Economy Act</i>	July 2007	<ul style="list-style-type: none"> • first target: 2006 levels in 2020 • increasing auction of allowances • \$12/tonne technology fund payment for compliance
Kerry-Snowe <i>Global Warming Reduction Act</i>	February 2007	<ul style="list-style-type: none"> • first target: 1990 levels in 2020 • offsets from biological sequestration
Sanders-Boxer <i>Global Warming Pollution Reduction Act</i>	January 2007	<ul style="list-style-type: none"> • first target: 1990 levels in 2020 • offsets from biological sequestration
McCain-Lieberman <i>Climate Stewardship and Innovation Act</i>	January 2007	<ul style="list-style-type: none"> • first target: 2004 levels by 2012 • grandfathering/auction split • 30% limit on offsets
Proposals in the House of Representatives		
Dingell-Boucher “Discussion Draft”	October 2008	<ul style="list-style-type: none"> • first target: 6% below 2005 levels by 2020 • auctioned/grandfathered allowances • increasing use of offsets: 5%-35% by 2024 • state authority for cap and trade programs (like WCI and RGGI) pre-empted
Doggett <i>Climate Market, Auction, Trust & Trade Emissions Reduction System Act of 2008</i>	June 2008	<ul style="list-style-type: none"> • first target: 1990 levels by 2020 • auctioned/grandfathered allowances • 25% limit on offsets
Markey <i>Investing in Climate Action and Protection Act</i>	June 2008	<ul style="list-style-type: none"> • first target: 2005 levels by 2012 • increasing auction of allowances • 30% limit on offsets
Waxman <i>Safe Climate Act of 2007</i>	March 2007	<ul style="list-style-type: none"> • first target: 2009 levels by 2010; 2% per year reduction 2011-2020
Olver-Gilchrest <i>Climate Stewardship Act</i>	January 2007	<ul style="list-style-type: none"> • first target: 2004 levels by 2012 • 15% limit on offsets

Climate Change Law Practice Group

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The group advises greenhouse gas emitters about regulatory compliance, risk management and environmental disclosure. We also advise emissions reduction project developers and cleantech companies about carbon finance, project structuring, corporate governance, IP protection, government relations and regulatory affairs. We have significant expertise in areas of renewable energy including wind energy, run of river hydro, biomass and fuel cell industries



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