



## California Extends and Strengthens Cap-and Trade Program

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*Kyle Danish*

In the wake of the Trump Administration's withdrawal from the Paris Agreement, a number of governors and mayors have pledged to come forward with ambitious climate policies and programs. California Governor Jerry Brown has been the drum major at the head of this parade of subnational climate warriors. On July 17, he scored a significant victory when the California legislature extended the state's flagship multi-sector greenhouse gas (GHG) cap-and-trade program through 2030.

The bill extending the program garnered two-thirds majorities in both the Senate and the Assembly, which reinforces the legal and political foundation for cap-and-trade in California. The program is now a primary means of meeting the state's ambitious 2030 emission limit, which equates to a reduction in GHG emissions of 40 percent below 1990 levels.

However, legislators also directed the agency implementing the program – the California Air Resources Board (CARB) – to make significant modifications to the current design. These modifications were designed to accommodate the concerns of stakeholders across the political spectrum. As a result, action now shifts to CARB, which will have to implement complicated and controversial rulemakings in the coming months.

### Background

**Cap-and-Trade.** CARB has operated the cap-and-trade program since 2012 as a means of meeting the state's 2020 emissions target. Under the program, CARB periodically distributes rights-to-emit (called "allowances") in an amount that corresponds to a declining emissions target (the "cap"). Covered entities, which account for approximately 80 percent of the state's emissions, are required to obtain and surrender an allowance for each ton of emissions. Entities that can reduce their emissions at low cost can sell surplus allowances to others that need them for compliance.

**Allowance Auction.** To date, CARB has distributed a large portion of the program's allowances via an auction, with the revenues going to support various state programs. CARB has distributed another portion of the allowances for free, including to companies that are in energy-intensive sectors and compete with companies that are in jurisdictions not subject to GHG regulation. Recipients can sell the allowances to covered entities and use the revenues to mitigate competitiveness impacts resulting from the cap-and-trade program, including higher costs for energy.

**Offsets.** In lieu of allowances, the cap-and-trade program has allowed regulated entities to cover a limited amount of their emissions (8%) with credits from "offset" projects. Under the offsets provisions of the program, CARB issues credits for projects that achieve emission reductions at certain sites that are not otherwise subject to GHG regulation, including forests, dairy farms, and rice cultivation operations. Projects can be in California or in other states. The availability of offset credits expands the compliance marketplace, thereby lowering costs.

**Linkage.** CARB is permitted to link the cap-and-trade program with programs in jurisdictions, provided the programs are of similar stringency and design. To date, the state has linked with a program in Quebec, and is close to establishing a link with Ontario.

### Key Stakeholder Issues During the Legislative Debate

During the legislature's consideration of bills to extend the cap-and-trade program, a number of issues came to the fore:

**Legal Validity of Auction.** Many stakeholders favored simply extending the existing cap-and-trade program through 2030. But it was not that simple. First, there were questions about whether CARB was empowered to implement the program after 2020 absent a direct grant of authority from the legislature.

In addition, a 2010 amendment to the state constitution cast a shadow of uncertainty over the validity of the allowance auction. The amendment provides that any state law imposing “regulatory fees” must be approved by a two-thirds vote of the legislature. Absent legislative action, therefore, the allowance auction could have been imperiled by litigation. An adverse court decision could threaten a significant source of revenues for the state – including those designated for the high-speed rail system particularly coveted by Governor Jerry Brown.

For these reasons, Governor Brown vigorously pushed the legislature for a two-thirds vote extending the cap-and-trade program. In an illustration of how California’s environmental politics are several clicks to the left of national politics, many industry stakeholders were siding with Brown. Because the stringent 2030 emission target was enshrined in state law back in September 2016, most companies preferred a known, market-based program for compliance over command-and-control alternatives. Many also hope to use their “banked” allowances in an extended program.

**Environmental Justice Issues.** In another illustration of the left-leaning composition of the state, Brown’s bid to extend the existing cap-and-trade program encountered headwinds from the environmental justice (EJ) community.

EJ advocates raised a number of [issues](#) with the cap-and-trade program. First, they claimed that the market-based flexibility of the program has allowed businesses to forgo not only on-site reductions in GHG emissions but also corresponding reductions in conventional, non-greenhouse gas pollutants. To be clear, the cap-and-trade program does not exempt facilities from limits on conventional and toxic pollutants. Nevertheless, during the legislative debate, EJ advocates were seeking facility-specific GHG limits because they reasoned that such limits would force co-benefit reductions in other pollutants – even though facility-specific GHG limits would undermine the efficiency of the cap-and-trade program.

EJ advocates have also been sharp critics of the offsets provisions. During the legislature’s deliberations, they pointed out that many offset projects are implemented outside the state, and claimed that these projects deprive California of GHG and monetary benefits. Yet, GHGs are globally-mixed pollutants, which means that a ton of emissions reduced in Colorado has the same climate benefit as a ton reduced in California. In addition, expanding the cap-and-trade market to offset projects provides economic benefits to the state in the form of reduced compliance costs for in-state regulated entities.

Nevertheless, the EJ community holds sway over a large portion of Democrats in the legislature, and therefore their concerns had to be addressed in some way in order to reach the needed two-thirds majority.

**Cost Control and Competitiveness.** Stakeholders also raised concerns about the potential costs of the more stringent program, and its impact on competitiveness. The state has been on track to meet its 2020 emissions with relatively modest impacts on the state’s economy. However, the state is moving into new territory with its 2030 emissions target. Between 2013 and 2020, the declining cap represented an emissions decrease of approximately 15 percent. In order to get from the 2020 target to the 2030 target, emissions will need to decline another 40 percent (from 334.2 MMT CO<sub>2</sub>e to 200.5 MMT CO<sub>2</sub>e). The more ambitious 2030 target raised concerns about potentially skyrocketing costs, which could be felt at the pump and in electricity prices.

The current program has certain measures aimed at moderating allowance prices; however, during the legislative debate, many stakeholders questioned whether these measures would be sufficient. There was a call to integrate measures in the program that would ensure that allowance prices (and therefore compliance costs) would not exceed certain levels.

In addition, companies in energy-intensive, trade-exposed sectors sought more targeted allowance allocations or other measures that would make it easier to keep their operations in the state.

## The Final Legislation (AB 398)

The final version of the bill extending the cap-and-trade program reflects efforts to address the various competing concerns of stakeholders.

**Extension and Use of Auction Revenues.** Both chambers passed AB 398 with two-thirds majorities chambers, thus providing a secure legal foundation for the allowance auction.

However, at the insistence of the handful of Republicans who crossed party lines to vote for AB 398, the legislature passed a second measure aimed at giving them a greater say over how auction revenues are spent. This second measure, Assembly Constitutional Amendment 1, will put a proposal on the ballot to amend the state constitution to subject the 2024 spending plan for auction revenues to a two-thirds vote in the legislature.

**Price Ceiling.** AB 398 directs CARB to establish a mechanism that would establish “price ceilings” for the program. Under this price ceiling mechanism, CARB would designate a particular allowance price at which it would make unlimited allowances available in auction. The price would increase over time as the emission cap declines. The price ceiling mechanism provides assurances that allowances prices cannot increase above the ceiling.

Earlier versions of the legislation specified a particular starting point for the price ceiling, i.e., in the range of \$60/mt CO<sub>2</sub> equivalent. In the final version of AB 398, however, the legislature vested in CARB the authority to establish the price ceiling through a regulatory process.

**Competitiveness Measures.** AB 398 authorizes CARB to continue allocating a portion of allowances to energy-intensive, trade-exposed companies; the portion declines over time in proportion to the declining cap. However, it also directs CARB to provide recommendations to the legislature on other possible statutory changes to minimize the shifting of emissions and jobs to other states – including a “border carbon adjustment” mechanism. Under previous legislative proposals contemplating such a mechanism, trade-exposed California companies would receive allowance cost relief for their sales to other states and out-of-state companies selling goods into California would be required to obtain allowances or otherwise pay a tax.

**Offset Limits.** In response to concerns from the EJ community, AB 398 tightens limits on the use of offsets. Starting in 2021, the limit on a covered entity’s use of offset credits drops from 8 percent to 4 percent, of which at least half must come from projects that are located in the state or “provide direct environmental benefits in state.” From 2025-2030, the overall limit increases to 6 percent, but half of the credits still must come from in-state projects.

The requirement for in-state projects is a significant constraint. Most offset project developers have found that the potential for cost-effective offset projects within California is quite low. As a result, these limits could significantly increase the compliance costs associated with the program.

**Local Air Pollution.** Notwithstanding the demands of EJ stakeholders, AB 398 does not incorporate facility-specific GHG limits on refineries or other major sources of conventional air pollutants, and in fact precludes CARB from imposing direct GHG emission reductions on refineries. Furthermore, AB 398 prohibits the state’s 35 air pollution districts from imposing their own GHG limits on facilities already subject to the cap-and-trade program.

To address local pollution issues, the legislature passed an accompanying bill (AB 617). AB 617 directs CARB to promulgate a new regime of requirements aimed at conventional and toxic pollutants. The regime will consist of community fence-line air monitoring systems, expedited requirements for Best Available Retrofit Control Technologies at major emitting facilities in heavily populated and disadvantaged areas, and new authorities for local air districts to levy increased penalties for non-compliance.

## Emerging Issues

**CARB Rulemaking.** Governor Brown is expected to sign AB 398, ACA 1, and AB 617 into law. Then, action will move to CARB. CARB had already been working on a package of regulatory [amendments](#) that would apply post-2020, and a [public hearing](#) is scheduled for July 27. AB 398 reflects some of CARB's proposals. However, CARB will need to revisit those proposed regulations in light of AB 398's new mandates. In particular, CARB will have to launch a process for setting a price ceiling for the program. The outcome of this effort could determine the ultimate impact of the program on the state's economy.

CARB also will have to revisit its required Scoping Plan, which is its comprehensive plan for meeting the state's emissions target. The plan encompasses not only the cap-and-trade program, but also the Low Carbon Fuels Standard, the Renewable Portfolio Standard, and other measures. In its most recent [version](#), which the agency in January, CARB had proposed facility-specific GHG limits for refineries equivalent to a 20 percent reduction. AB 398 preempts such limits.

**Effect on Carbon Markets.** AB 398 should place California's carbon markets on firmer footing. In recent years, the market participants have wrestled with litigation uncertainties related to the auction, and questions about whether and how banked allowances could be used after 2020. Enactment of AB 398 goes a long way to resolving those uncertainties.

**Effects on Other State Efforts.** California's successful, bipartisan extension of its cap-and-trade program is likely to put some wind behind the sails of other state and local climate policy initiatives. These include initiatives in Oregon and Washington. In addition, AB 398 could spur more concerted efforts by the Eastern states that comprise the Regional Greenhouse Gas Initiative (RGGI), a multi-state cap-and-trade program addressing CO<sub>2</sub> emissions from power plants. Depending on the outcome of gubernatorial elections in November, it is possible that New Jersey and Virginia could join the ranks of the RGGI.

Though California's passage of AB 398 might provide political inspiration for multi-state efforts, it might actually complicate the process of having California itself participate in such efforts. California has adopted specific criteria for linking its cap-and-trade program with programs in other jurisdictions. Among other things, these criteria are intended to ensure that a linkage partner has a program of comparable stringency. Yet, neither the RGGI nor California's progressive Pacific Northwest appear close to adopting policies that equate to a \$60/ton carbon price. Therefore, at least in the near term, California's policy ambitions might hinder its efforts to forge links with other states.

## For more information

Van Ness Feldman represents clients in California on a range of environmental, climate, and energy matters and participates actively in proceedings at the California Air Resource Board. For more information, please contact [Kyle Danish](#) or any member of the firm's [Environmental](#) practice.

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