Cap & Trade

GREENHOUSE GAS CAP & TRADE PROGRAM

WESTERN CLIMATE INITIATIVE PROGRAM NOW OUTLINED

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Documents Released

On Wednesday March 5th the Western Climate Initiative released two documents outlining the scope of the greenhouse gas cap and trade program planned for the western United States. These proposals answer many questions regarding how greenhouse gases will be regulated, while leaving other points undecided. This article outlines the proposals and the key points for Oregon companies.

Western Climate Initiative

WCI

The Western Climate Initiative (WCI) is a regional organization formed in February of 2007 and currently consisting of seven western states (Oregon, Washington, California, Montana, Utah, New Mexico & Arizona) and two Canadian provinces (British Columbia and Manitoba). Several US and Mexican states and Canadian provinces have joined as "observers." (See Futornic, ***Insider*** #424/425 and Duncan, ***Insider*** #430) The purpose of WCI is to fill the void left by the lack of federal greenhouse gas regulation and to create a regional greenhouse gas strategy. For California, the WCI process also minimizes the likelihood of businesses leaving the state in the wake of their 2006 greenhouse gas regulatory scheme. (See Wood, ***Insider*** #400) One of the first steps in the process was that the member states established a regional greenhouse gas emissions reduction goal of 15 percent below 2005 emission levels. States separately established state-specific goals and some are much more aggressive. For example, Oregon established a goal of reducing greenhouse gas emissions by 75 percent below 1990 levels by 2050 and Washington has proposed reducing greenhouse gas emissions by 50 percent below 1990 levels by 2050. A primary aim of WCI has been to design a greenhouse gas cap and trade program that would assist member states in attaining both their own goals and WCI reduction targets.

Cap and Trade

Cap & Trade Option

A cap and trade program is one of several options for reducing **g**reen**h**ouse **g**as (GHG) emissions. In its simplest form, such a program consists of identifying a group of sources from whom society wants to reduce GHG emissions. The regulator identifies a maximum number of tons per year of emissions that will be allowed. Sources are then either given or sold allowances, each of which constitutes a license to emit one ton of GHG. The number of allowances is then reduced periodically until the given amount of reductions is achieved. The expectation is that the market will determine where the least-cost points of reduction are located. Economic theory suggests that a source that can reduce its emissions more cheaply than others will do so and then trade any excess allowances freed up by its emission reductions to other market participants. Theoretically, this market will ensure that the desired GHG reductions are achieved at the least cost.

Prior Use

Cap and trade programs have been used with great success to control other air pollutants. The US Environmental Protection Agency's (EPA's) acid rain program is generally viewed as the first and best of cap and trade programs. The acid rain program arose out of the 1990 federal Clean Air Act Amendments. It was reviled by most environmental groups at the time based on the perception that it allowed companies to "pay to pollute." This program required most fossil fuel fired electrical generation units servicing generators greater than 25 megawatts to install continuous emissions monitors and to ensure that they had sulfur dioxide (SO_2) allowances equal to the annual emissions. The program provided incentive for power plant owners to install controls so that they could decrease their need for allowances or free up allowances they already owned. Excess allowances could then be sold. Liquid markets for SO_2 allowances were established and documentation of emissions and trades are tracked through EPA's Clean Air Markets Division. The European Union (EU) has a GHG cap and trade program that was heavily modeled on the US acid rain program.

WCI Cap and Trade

Design Complexity

While the concept of establishing a cap and trade program is relatively simple, the actual design and implementation is extremely complex. Any cap and trade program must address several key components. First, it must include a robust emissions reporting and tracking program in order to ensure that the

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participants are covering their emissions. Second, there must be an agreed upon means of distributing the allowances that equate to the right to emit one ton of GHG per year. Distribution options for these allowances include: giving them away at no cost; selling them for a flat fee; or auctioning them off to the highest bidder. Rules can be established limiting the holding of allowances to program participants (so as to reduce speculation) or they can be freely purchasable and tradable by any party. Third, there must be a common approach to the generation and use of offsets. Offsets are qualified reductions generated by specific non-regulated entities that can be introduced into the cap and trade program and used in lieu of allowances. Other cap and trade programs (e.g., the EU program and the northeast US' Regional Greenhouse Gas Initiative (RGGI) program) severely limit who can generate an offset and how many can be introduced into the system. Absent such restrictions, offsets could flood the market, reduce the incentive to decrease emissions domestically and devalue existing allowances. Finally, there need to be mechanisms to minimize the potential for GHG emitters to avoid regulation through relocation to an unregulated region (i.e., "leakage" from the program) and to address the unique attributes of certain sectors — such as power generation.

Other Programs

WCI Subcommittees

In order to grapple with the array of issues inherent in establishing a cap and trade program, the WCI established subcommittees. Five areas (reporting, allowances, offsets, electricity and scope) were carved out for specific subcommittee consideration. Member states participated in these committees, drawing up a set of design options for each subcommittee that were shared with the public in January 2008 (see Kranz/Futornick, ***Insider*** #431). Since that time the subcommittees have been meeting behind closed doors (the public is not allowed to attend or participate) with the goal or generating proposals for consideration by the full WCI membership. The proposals first scheduled for release were those of the Scope Subcommittee and the Electricity Subcommittee. These proposals were released in March 2008 and give important insight into how the GHG cap and trade program will function.

Scope Subcommittee Proposal

Regulation Proposal

The primary recommendation on scope was that the cap and trade program regulate stationary industrial sources and the electricity sector. Several options were open to WCI for establishing the scope (i.e., who will be regulated) of a cap and trade system. One model would be to limit the program to just the electricity generation sector. The northeast US' RGGI program takes this approach, focusing, for the time being, exclusively on electric generating units 25 MW or greater. Another model for the scope of a cap and trade program would be to include all sources of greenhouse gases. The WCI Scope Subcommittee proposed something in between these two extremes. In their proposal they suggested that only the stationary industrial sources and the electricity sector be regulated. Transportation and residential/commercial natural gas and oil usage are being recommended for further consideration, but not regulation at this time. It appears that the subcommittee members could not reach consensus on these sectors and so are focusing on electricity and stationary sources for now.

Threshold Questions

Probably the most eagerly awaited aspect of the Scope Subcommittee's work was missing from the March proposal. If the cap and trade program is extending to industrial sources, it is generally agreed that there will be some sort of cutoff below which a source will not participate. For example, on March 13, 2008 Washington's Governor Gregoire signed into law Engrossed Second Substitute House Bill 2815 which requires that state's Department of Ecology to establish a GHG reporting program for motor vehicle fleet operators emitting at least 2,500 tonnes (metric tons) of GHG per year or other operations that emit at least 10,000 tonnes of GHG per year. This type of threshold is expected to be applied to determine those sources that must participate in a cap and trade program. Obviously the recommended threshold is of fundamental importance to sources. However, the Scope Subcommittee gave no indication in its proposal of what that threshold would be. The debate over the threshold will thus continue. However, there is a reasonable chance that for most non-generating industrial stationary sources the threshold will be 25,000 tonnes/year given that this is the general California mandatory reporting program threshold. It seems unlikely that the threshold would be any higher than 25,000 tonnes/year and it could drop down as low as 10,000 tonnes/yr (the threshold for electrical generating units could be lower still). It is possible that different states could adopt different thresholds, although this would create implementation issues.

Electricity Subcommittee Proposal

Current Proposal

In relation to the electricity sector, WCI announced that it wants to regulate all sources that generate power within the WCI region as well as the first entity within the WCI territory that handles power generated outside the WCI territory. The most intelligent means of regulating the electricity generation

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Selected Approach

sector is to regulate the point of generation (i.e., the power plant). However, this approach falls apart where, as in WCI, not all states within the WCI members' electrical "grid" (i.e., the Western Electricity Coordinating Council or WECC) are WCI members. Therefore, when electricity generated in Wyoming or Nevada is wheeled into and used by a WCI member state, that power would not be addressed if the cap and trade focused just on generators. This would give a significant price advantage to WECC generators operating in non-WCI states and selling into WCI states. Therefore, the Electricity Subcommittee recommended that a "first jurisdictional entity" approach be adopted at this time. Under this approach, the point of regulation would be the first entity within a WCI member state to handle electricity. This could include a rural consumer owned utility that just wheels power across its transmission lines without selling any of the power. If the generation unit is located within a WCI member state, then the first jurisdictional entity would be the generator. WCI stated that once all the states within the WECC join WCI, the "first jurisdictional entity" approach will go away and just the generators will be regulated. However, until that time they are recommending that this dual generator/first jurisdictional entity approach would govern.

State-to-State Sales

The first jurisdictional entity approach will cause some confusion as WCI has not determined how they will regulate power generated in one WCI state and sold into another WCI state. While it might appear that these emissions should be regulated at the point of generation and that state get credit (for better or for worse) for emissions within its boundaries, there is a strong interest in the state where the power is consumed having to take credit for the associated emissions. The tension is that a state seeing a plant get more efficient will want to take credit for those reductions in demonstrating compliance with its GHG reduction goal. This is a point that the WCI will continue to work on. One thing the subcommittee keeps repeating is that the point of regulation is not necessarily the same point to which allowances are allocated. However, getting this concept to work intelligently in all cases will be an interesting challenge.

More Deliberations

The next few months will include a series of additional announcements about the recommendations from the various WCI subcommittees. These will ultimately be wrapped into what all hope is a coherent cap and trade program. While the recommendations from the subcommittees will obviously have tremendous sway on how the whole program is structured, any program will ultimately have to be approved by the member states in the context of the WCI deliberations. Presumably, most of those states will then have to obtain authority through the individual state's legislative/regulatory process. Washington State granted its Department of Ecology authority to work with WCI in developing a cap and trade program and ESSHB 2815 requires that they report to the legislature specific recommendations for approval and a request for authority to implement a cap and trade program. A hard deadline of January 1, 2012 was included in the bill for implementing that program. The Oregon legislature will presumably weigh in on the design of the cap and trade program in region as part of the 2009 session. This process of individual legislatures debating and approving the work of WCI could result in significant state-to-state variations in how the ultimate program in implemented.

Conclusion

Significant Costs

Oregon sources should be aware of the key work to be completed by the WCI in the upcoming four months and the legislative efforts that will follow. In order for a cap and trade program to achieve the goal of reducing greenhouse gases, it must impose significant costs on emitters of greenhouse gases. Emitters will then either spend capital reducing emissions, pay for allowances to maintain business as usual or move to states or countries where they need not pay such additional costs. Either way, these costs will be passed on to consumers who likewise will make choices as to whether and how to reduce consumption. About the one sure component of the cap and trade program is that it will result in significantly greater energy costs.

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Western Climate Initiative website: The WCI Subcommittee proposals are available from www.westernclimateinitiative.org

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