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GREENHOUSE GAS CAP & TRADE PROGRAM

NEW DETAILS EMERGE

WESTERN CLIMATE INITIATIVE OUTLINES KEY PROGRAM ASPECTS

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New Proposals

On April 3rd and 4th, 2008, the Western Climate Initiative (WCI) released its proposed program design for three of the most critical elements of the looming greenhouse gas (GHG) cap and trade program. Last month WCI released its proposal for the scope of the GHG cap and trade program and how it proposes to regulate electricity. On April 3rd and 4th, WCI released its proposals for: 1) Reporting; 2) Allocation of Allowances; and 3) the handling of Offsets. This article discusses ideas raised in the proposals as well as information shared in a meetings with WCI representatives in Oregon and California. Each of the three program areas is discussed below.

Western Climate Initiative

Background

The 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), two Canadian provinces (British Columbia and Manitoba); a number of other US and Mexican states, as well as Canadian provinces, participate in WCI as observers. As discussed in last month's ***Insider***, the purpose of WCI is to fill the void left by the lack of federal greenhouse gas (GHG) regulation and to create a regional greenhouse gas strategy. WCI's primary focus is on the development of a GHG cap & trade program.

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. 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 Scope Subcommittee and the Electricity Subcommittee proposals were released in March 2008 (see Wood, ***Insider*** #433). As noted, the Reporting, Allowances and Offsets subcommittees released draft design recommendations in April.

Reporting Subcommittee

WCI v. State Efforts

It is important to note that Oregon is currently developing its own GHG reporting program (see next article). These are a separate "state-only" set of requirements, though efforts have been made to address compatibility. California already has a GHG reporting program that requires submittal of 2008 GHG emission data in 2009. California's WCI representatives have openly acknowledged that their state's reporting program will likely need to change in response to WCI. Similarly, each WCI member-state's GHG regulatory requirements should be considered in flux.

TCR Tie-In

Two of the WCI's fundamental reporting concepts come as no surprise. First, the WCI stated that it wants to rely on The Climate Registry (TCR) infrastructure. This is not surprising as WCI member-states form the backbone of TCR and are invested in its success. However, the TCR's recently-released general reporting protocol addresses *voluntary* reporting programs and as such does not fit neatly into mandatory reporting programs such as the WCI. Therefore, the other unsurprising acknowledgement was that each state has its own unique needs and structures. The underpinnings of the WCI's reporting program will need to come from the WCI member-states and not TCR. These concepts framed the Reporting Subcommittee's ideas about how the WCI would define the reporting program and its associated implementation schedule.

State Prerogatives

Reporting Entities

WCI's first reporting program element addressed who must report. Two approaches had been considered: (1) having just GHG sources within the capped industry sectors and above the applicability threshold report; and (2) having all GHG sources report (i.e. both the capped sources as well as sources outside the capped industry sectors). The current proposal suggests a third approach. Specifically, WCI proposes having the capped sources report, but also potentially require the sources within the capped sector but below the applicability threshold and sources categories outside the cap report. No detail is given on how the "outside the cap" sectors would be identified for reporting. However, the proposal indicates that, based on the previous scoping proposal, the outside the cap sectors targeted for reporting could be slated for phase-in into the cap.

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Reporting Timeline

WCI also discussed the idea of when reporting should commence. Strong disagreement exists among some interested parties as to whether the reporting program should commence at the same time as the cap and trade program or whether there should be a period of data collection followed by a more informed structuring of the cap and trade program based on the actual data. WCI proposes a “split the baby” approach whereby reporting is proposed to start before the cap and trade commences, but that the electricity generation sector, and possibly some other sources, could be placed under a cap and trade program fairly quickly.

Allocations Subcommittee

Contentious Issues

How allowances will be handled under the ECI cap and trade program is a highly contentious issue and likely is the most closely watched aspect of the program. Key aspects up for debate include whether allowances should be given away, sold at a fixed fee, or auctioned to the highest bidder. If an auction is used, the next question is whether each state should conduct its own auction or whether there should be one centralized auction. Another key point being debated is whether allowances should be distributed based on actual emissions or output capacity. Answers were proposed to many of these questions in the current proposal, but the final answers may not be known until WCI has wrapped up its process and each member-state has fully adopted its implementation program.

Thresholds & Baseline

One threshold question arising in any cap and trade program is how to decide the baseline emission rate and how to then allocate allowances to states and capped sources. WCI current proposal is to establish a regional cap with each member-state issued a percentage of that cap. Each state would then be free to determine how it would distribute its portion of the cap to capped entities. What people are particularly keen to know, however, is just how those member-state GHG budgets will be established. One possibility is to set the budget based on actual GHG emissions in a baseline year. Another would be to set the budget relying on an output-based benchmark approach. In order to understand this approach, imagine two mythical states. State A has one single source of greenhouse gases, a 500 megawatt (MW) power plant. State B has no sources of greenhouse gases, but has a 500 MW hydropower project. Under an actual emissions approach, State A would receive an allocation of allowances related to the power plant’s emissions and State B would receive nothing. Under a benchmark approach, State A and State B would receive an equal number of allowances because each is generating 500 MW of electricity. State B would receive a windfall under the benchmark approach as it would not need the 500 MW worth of greenhouse gas allowances and could sell them to State A, which would be under-allocated under a benchmark approach. Therefore, this approach serves to give a subsidy to non-emitting generation assets. This approach is most easily understood in relation to power plants where a benchmark is more easily expressed. However, WCI is proposing to regulate more than the power sector and establishing benchmarks is much more difficult for other industries. The WCI’s current allocation proposal does not address this issue and WCI state representatives have said that the matter is still under intensive debate within WCI.

State Limits

Once the number of allowances a state will receive is identified, the proposal indicates that each state should be more-or-less free to pass them around as it chooses. However, some key limits were proposed on state discretion. The most important is that a state would have a minimum number of allowances that must be auctioned. The precise minimum has not be determined, but that minimum will lie between 25 and 75 percent of the state’s allowance budget. The remainder of the allowances is to be given away. However — while one might not pick it up from the proposal document — WCI representatives indicate that “given away” does not necessarily mean “given away *for free*.” It is possible that a state may choose to sell 75 percent of its allowances at its best estimate of market prices and then auction the remaining portion. Obviously, if the combined sale/auction process is generating tens of millions of dollars of revenue to the state, there will be intense political pressure to divert some or all of those funds to other purposes. This makes many nervous about an approach that could become a major state revenue mechanism.

Industry Impacts

How different states handle their allocation process will have incredible competitive impacts to industries. Multiple and various competitive influences could potentially affect the viability of manufacturing in member states. If, as proposed, allowances can freely be used anywhere in the WCI region and are freely interchangeable between industries, many sources may find themselves priced out of the market. Consider if State X gives away 75 percent of its budgeted allowances for free, while auctioning the remainder and State Y auctions 75 percent of its allowances and sells the remainder at estimated market price. A source in State X would be much more flush with cash and able to outbid a source in State Y for excess allowances it might need. If you then figure in the competitive disadvantages of coastal commodity manufacturers (who are more sensitive to foreign imports due to transport costs) as compared to inland commodity manufacturers, additional disparities arise. Sources who are net sellers of allowances might

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prefer a system that drives prices up, but that assumes that they are able to obtain some of those allowances for free. If all allowances are sold at or near market prices, the beneficiaries of the system are likely to be only those third parties skilled in exploiting arbitrage opportunities.

Offset Subcommittee

Specifics Delayed

On April 4th WCI also released its proposal for how it intends to address offsets under the cap and trade program. Of the three proposals, this was the least fleshed-out. Its lack of specifics was somewhat expected as for months WCI representatives have said that offsets would be the last aspect of the cap and trade program to be fully developed.

Offsets Creation

Offsets are emission reduction projects undertaken by sources not subject to the cap and trade program (except in unusual circumstances). If the emission reduction project meets the qualifying criteria, the reductions (i.e., offsets) can then be sold to sources that are subject to the cap and trade program and used to cover their allowance requirements. By definition, offsets expand the size of the cap and dilute the emission reductions represented by the initial cap. Questions arise as to who can generate offsets, exactly how qualifying offsets can be generated, and how many offsets can actually be sold into the compliance market. The current proposal is light on detail, but a few elements of the program likely to come out of WCI process can be divined.

Limiting Use

It is clear from the proposal that WCI wants to limit the ability for offsets to be used by capped sources to meet their allowance obligations. WCI proposes to give preferential treatment to offset projects that occur within the WCI region. Depending on whether you are a net buyer or seller of offsets, you may consider this good or bad. The amount of offsets that will be allowed into the program will almost certainly be capped. The level at which they will be capped is not stated. However, comments from WCI representatives suggest that the offset utilization level will be capped at 15 percent of the total allowances. What type of projects will be credited is not discussed, but it is possible that WCI could follow the example from the US northeast's Regional Greenhouse Gas Initiative (RGGI) program and limit offsets to particular categories. While it would seem natural that the level of allowable offsets would be indexed to the allowance price, that concept is not discussed in the proposal. Again, it would be reasonable to expect that the RGGI example will be influential. Under RGGI the percentage of offsets that can be used increases as the market price of allowances increases.

Early Action Limits

WCI has stated that it wants to give credit for early action. In relation to offsets, this could translate into letting sources that implement projects prior to establishment of the cap and trade program get credit, in the form of offsets, for their projects. However, discussion within WCI concerning the baseline year for offsets (which may or may not be the same as the baseline year established for other program purposes) is still in its early stages. Some WCI member-representatives have indicated that it is unlikely that projects implemented prior to WCI's program implementation will be eligible for offset status. If WCI were to follow RGGI's example, projects implemented many months before finalization of the program would not be eligible to generate offsets.

Conclusions

Questions Remain

The proposals released in April provide the most tangible insight thus far available into this regional program that will soon apply in all WCI states and cause fundamental impacts to our economy. Clearly, there will be winners and losers in any program. While the current proposals offer insight into who those may be, they are far from clear. However, we can conclude that it is likely that the cap and trade program is a few years off and that the number of auctioned allowances will start off at a minimum of 25 percent and increase over time to 100 percent. We can also conclude that the use of offsets will be severely limited and that many, if not most, of the voluntary emission reduction "credits" created to date will not be useful under the cap and trade program.

In considering these WCI proposals, however, it is critical to remember that WCI can only propose a program. The program ultimately put in place must first be adopted by WCI member-states. It is highly likely that each individual state will be unable to resist adjusting the WCI model program to benefit its constituents. In short, until adopted into rule and/or statute, it is impossible to know exactly how the program will work (or not). That should not prevent sources, in and out of the cap, from planning for what lies ahead.

Additional Information:
The WCI Subcommittee proposals are available online at: www.westernclimateinitiative.org.