



Issue #1. Excessive Price Volatility and Sustained High Allowance Prices

Issue in Brief:

From a policy perspective, exceedingly low and exceedingly high allowance prices both present risks to regulated entities and the U.S. economy. If the cap is poorly designed, allowance prices could rise much higher than anticipated – harming businesses and consumers. Conversely, a “crash” in allowance prices could discourage emission reductions over the short term, and hinder the long-term investments that are needed to meet ambitious long-term GHG reduction targets. Uncertainty surrounding the pace of technological change, economic growth, the cost of abating GHG emissions, and the integrity of the GHG market makes it difficult to design a cap that provides price stability and avoids excessive price swings.

H.R. 2454 addresses these concerns somewhat by providing for a \$10 / ton price “floor” for auctioned allowances, which would increase each year at a rate of 5% over the rate of inflation. The bill does not place a firm ceiling on allowance prices, but relies on certain “cost-containment” mechanisms (such as offset credits, international allowances, banking/borrowing, and strategic reserve auctions) to moderate the price of allowances. These mechanisms may be insufficient to contain allowance prices if emission reductions prove costlier or slower than anticipated.

Issue #2. Allowance Retention

Issue in Brief:

H.R. 2454 provides for a significant quantity of allowances to be distributed or “allocated” directly to various public agencies and private entities. In order to avoid a supply shortage of allowances, especially in the early years of the program when the supply of offset credits is likely to be small, allowances held by allocation recipients without a compliance obligation, other than electric LDCs, must rapidly enter active trading and become available for covered entities to purchase for compliance. If allowances are instead retained by allocation recipients, the resulting excess demand could cause harmful price spikes. Although H.R. 2454 provides for annual direct allocations of allowances to a variety of public programs and private recipients, the bill fails to address the possibility of allowance retention. Public agencies might retain allowances because of administrative delays or because the programs receiving allowances are under-subscribed. Private entities might retain allowances in order to maximize their value over time or submit them for compliance in a later period. The allocations most susceptible to retention represent approximately 21% of the cap in 2012 and 2020, suggesting that policy intervention is appropriate to ensure that allowances held by entities without a compliance obligation, other than electric LDCs, quickly enter trading and become available for compliance.

Issue #3. Implementation Schedule

Issue in Brief:

The cap-and-trade provisions of H.R. 2454 call on EPA and other federal agencies to undertake approximately 66 rulemakings, about 31 of which are rulemakings necessary to establish “core” elements of the program such as emissions monitoring and reporting; management of auctions; allowance allocation mechanisms; offset credit administration; etc. In order to commence a cap-and-trade program in 2012, EPA would have to issue draft regulations, take public notice and comment, issue final regulations, and move to implement those regulations all within roughly two years. Covered entities would also have to be ready to comply within two years, at the very least by implementing emissions monitoring and reporting systems; the time available for compliance would, in practice, be even more limited since covered entities would in many cases have to wait for EPA to issue regulations before knowing what systems would be required for full compliance. This is an extremely aggressive timetable, especially compared to the lead time provided for the implementation of other emission trading programs. For example, the first and very limited phase of the sulfur dioxide trading program established under the 1990 amendments to the Clean Air Act did not take effect until January 1, 1995 – more than four years after the enactment of the amendments. Similarly, EPA’s final rule for a nitrogen oxides trading program provided a lead time of 4.5 years from the date the rule was promulgated. The economy-wide cap-and-trade program proposed in H.R. 2454 is far larger and more complex than either of these regulatory efforts, and it is not realistic to expect that the program can be implemented in less than half the time provided for those prior programs.

Issue #4. Insufficient Offset Supply

Issue in Brief:

As recognized in the Environmental Protection Agency's (EPA's) economic analysis of H.R. 2454, a robust supply of offset credits is vital to containing the cost of allowances. H.R. 2454 includes several provisions that may unnecessarily constrain the supply of offset credits and thereby increase the overall cost of the cap-and-trade program. Notable examples include the following:

- **Devaluation of international offset credits.** Even though international offset credits would be subject to the same rigorous quality standards as domestic offset credits, H.R. 2454 subjects international offset credits to a 20% “discount” beginning in 2018. This discount makes international offset credits unnecessarily costly.
- **Performance standards.** Section 811 of the bill requires EPA to issue performance standards within 10 years of enactment that are designed to ensure that at least 85% of industrial sector GHG emissions are either covered by the cap or subject to a performance standard. In addition, states would be permitted to issue their own performance standards for stationary sources. Because offset credits can only be issued for GHG emission reductions in excess of those required by law, these performance standards could eliminate many profitable opportunities for offset projects.
- **NSPS for uncapped sources.** H.R. 2454 also requires EPA to establish New Source Performance Standards (NSPS) for uncapped industrial GHG sources, including significant sources of methane emissions such as landfill gas and other biomass sources. These NSPS standards, once they take effect, will make these potential reductions ineligible for the offset program, since they would now be required by law. The prospect of NSPS standards would also have a negative environmental impact, by discouraging firms from reducing emissions at these sources as rapidly as they would if given offset credits as an incentive. To ensure an adequate supply of domestic low-cost offset credits

for LPPC members and other covered entities, and to encourage rapid emission reductions from these sources, legislation should ensure that the NSPS program does not render landfill gas and other biomass projects ineligible for offset credits.

- **International agreement requirement.** International offset credits would only be recognized pursuant to new bilateral or multilateral agreements with host countries. Given the other safeguards for offset credit quality in H.R. 2454, and the reality that most international offset credit projects will be registered through Kyoto Protocol offset programs, the agreement requirement should be re-examined.
- **Early offset supply.** There is a significant likelihood that few or no offset projects will have been approved once the cap-and-trade program commences. It may take several years for EPA to complete the rules for administration of offset credits and develop a robust “pipeline” of applications. Proposed CAA § 740 attempts to address this problem by providing “early” offset credits for projects that are already approved and registered with existing offset credit programs meeting certain quality criteria. This supply of offsets could be expanded by continuing to recognize the offsets approved through these programs until the federal program is fully functioning and by providing resources to these state and regional programs during the implementation phase of the program to allow them to qualify additional offset projects.

Issue #5. Relationship to Other Federal Law

Issue in Brief:

A key objective for many within industry is to ensure that the cap-and-trade program proposed under H.R. 2454 is the exclusive means of regulating GHGs at both the federal and state levels, in order to avoid needless duplications and inconsistencies among GHG mitigation programs. At the federal level, H.R. 2454 may fall short of this objective in the following areas:

- **NSR and NSPS for Capped Sources.** Although the bill generally prevents EPA from regulating GHGs under the New Source Review (NSR) program, and limits New Source Performance Standards (NSPS) to stationary sources of *uncapped* GHG emissions, both provisions are subject to an exception where EPA determines that regulation is appropriate due to effects *other* than climate change effects (see proposed CAA Sections 811(b), 834). Because non-climate change effects could conceivably include ocean acidification, environmental NGOs have suggested that this exception would authorize EPA to regulate almost any capped GHG sources under NSPS and NSR. This would allow EPA to effectively layer a command-and-control regime on top of the market-based incentives that H.R. 2454 seeks to establish through the cap-and-trade program.
- **Other federal laws.** In recent years, environmental NGOs have filed climate change-related claims under the Clean Water Act, Endangered Species Act, and federal common law. Although a federal court could be persuaded that these statutes are impliedly displaced by a comprehensive climate change regulatory scheme, the bill does not clearly bar such claims from proceeding or new claims from being filed.

Issue #6. Increasing Stringency of the Cap by Lowering Emission Thresholds

Issue in Brief:

For certain industrial sources, fuel and GHG producers, and natural gas local distribution companies, the emission threshold that triggers inclusion in the cap-and-trade program is 25,000 tons CO₂-e per year. The bill allows EPA to include sources that emit as little as 10,000 tons CO₂-e per year in the cap-and-trade program after 2020, upon making certain findings concerning the economic viability of lowering the threshold. The analysis EPA prepared for the Preamble to the proposed GHG Reporting Rule suggests that this lower threshold would dramatically increase the number of covered facilities, while increasing the proportion of U.S. emissions covered by as little as one percentage point. Although the incremental increase in emissions covered by the cap at an emission threshold of 10,000 tons CO₂-e per year is small, a concern exists that including these smaller sources in the cap and trade program without adjusting the size of the cap could place upward pressure on allowance prices by increasing the stringency of program.

Issue #7. Limitations on Use of Allowance Allocations to LDCs

Issue in Brief:

In addition to the allowance retention issue mentioned above, the allocation of allowances – particularly to electric LDCs – raises several practical concerns:

- **Permitted use of allowances.** The bill states that electric LDCs are to use allowance allocations for the benefit of ratepayers; are not to use allowances to provide consumption-based rebates to non-industrial customers; and must provide a ratable share of any allowance rebates to prevent rate increases for industrial ratepayers. This language is exceedingly vague and provides little guidance as to what EPA will consider “beneficial” (especially for purposes of auditing and levying penalties). In addition, EPA is charged with the responsibility of developing rules to ensure the benefit of allowances is passed through to consumers, in accordance with the preceding statutory requirements.
- **Penalty for LDC misuse of allowances.** The bill provides that each allowance that EPA determines has been misused will constitute a separate violation of the Clean Air Act. This provision could result in heavy financial hardship for LDCs (and, ultimately, higher rates to consumers), and presents a significant risk since so little guidance for the use of allowances is provided.
- **Lost opportunity to use allowances to finance transition to low-carbon electricity use.** Research has indicated that the most inexpensive way to reduce GHG emissions is to implement energy efficiency measures, yet individual consumers (for various reasons) have been slow to take up these technologies. The lack of clarity on whether funding energy efficiency measures and renewable energy as a legitimate use of allowance value could result in a significant lost opportunity to fund long-term cost-effective investments in energy efficiency and renewable energy. The lack of guidance to LDCs also increases the likelihood that the much-feared “rate shock” resulting from GHG regulations will simply be deferred to the future, when wise use of allowance value

could provide the assistance that consumers require to make the transition to low-carbon electricity use.

Issue #8. GHG Performance Standards for Coal-Fired Power Plants

Issue in Brief:

The bill requires that new coal-fired power plants to install carbon capture and sequestration (CCS) technology and achieve minimum federal GHG performance standards. The bill currently requires that coal-fired power plants receiving Clean Air Act permits after January 1, 2009 sequester at least 50% of their overall GHG emissions by no later than 2025, with the possibility of an earlier compliance deadline if EPA makes certain findings regarding the commercial diffusion of CCS technology. Generating units permitted after January 1, 2020 would be required to achieve a 65% sequestration rate upon commencing operation. The CCS bonus allowance provision of H.R. 2454, is the principal source of financial support to assist in achieving these performance standards. One key policy issue is whether the timetables and milestones for achieving the performance standards in the bill are realistic, and whether the level of resources devoted to commercializing CCS is adequate to meet the demands of the overall cap-and-trade program and the performance standards for coal-fired facilities.