

Waxman-Markey's Cap and Trade Provisions

In June 2009, the U.S. House of Representatives passed the 1,427 page American Clean Energy and Security Act (ACES), also commonly referred to as "Waxman-Markey." ACES addresses a wide range of energy issues, but its most newsworthy and controversial provisions are those aimed at reducing greenhouse gas (GHG) emissions through a "cap-and-trade" program. Below are the highlights:

Regulation of GHG Sources

ACES would impose compliance obligations on GHG¹ emissions from "covered entities," including both "upstream" and "downstream" emitters. Downstream covered entities generally include stationary sources, such as power plants and manufacturing facilities, that emit more than 25,000 metric tons per year of GHGs². Upstream entities include producers and importers of petroleum fuels, natural gas distributors, and producers of industrial gases. Covered entities would be obligated, at the end of each year, to submit to EPA one "emission allowance" or other "offset credit" for each metric ton of CO₂e attributable to that entity in that year.

Cap and Trade in a Nutshell

The total number of emission allowances or other forms of credits available for use by a covered entity to comply with its GHG obligations would be restricted – the "cap" component. In effect, the government would issue a new form of supply-restricted currency that can be freely bought and sold – the "trade" component. Other forms of credits would also qualify, most notably "offset credits" that could be created by undertaking an approved project to reduce or "offset" GHG emissions.

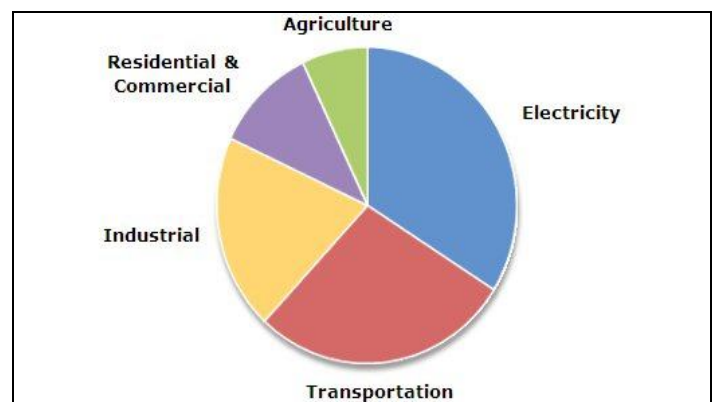
The resulting available supply of emissions and credits would be gradually but significantly reduced between 2012 and 2050, presumably making each allowance or offset credit increasingly scarce (and valuable), creating market pressures that presumably would result in the most efficient GHG reductions. As passed in the House, ACES would require reductions of aggregate GHG emissions from covered entities to a level that is 3% below 2005 levels in 2012. ACES specifies annual reduction targets from 2005 levels of 17% by 2020, 42% by 2030, and 83% by 2050. Estimates from federal agencies and third parties vary significantly as to the likely resulting value of credits (and the consequent "cost of carbon").

¹ GHGs include carbon dioxide (CO₂), methane, nitrous oxide, sulfur hexafluoride, HFCs emitted from a chemical manufacturing process, any perfluorocarbon, and nitrogen trifluoride.

² The measurement of GHGs is normalized to account for the different "global warming potential" (GWP) of the different GHGs. The resulting common unit is referred to a "CO₂ equivalent" or CO₂e, and is expressed in metric tons (MT). ACES would establish a GWP for methane, for example, that is 25 times greater than CO₂, so one ton of methane emitted would be converted to 25 metric tons of CO₂e.

Did you know?

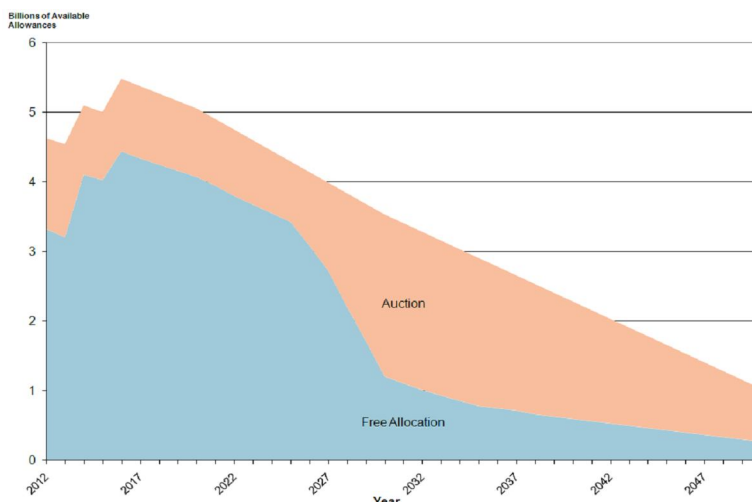
U.S. GHG Emissions By Source Category, Per U.S. EPA



Distribution of Allowances

ACES contains a complex allowance distribution system that includes a combination of auctions and free allocations. Some free allocations would be made to specified regulated entities (particularly utilities), some to assist people affected by the anticipated hikes in energy prices, and some to a patchwork of special interests and projects. For excellent graphic depictions of the declining cap and the allocation of allowances, see pewclimate.org.

EPA estimates the value of an emission allowance would be in the range of \$12 to \$15 in 2015 and would approach \$20 in 2020.



Auctioned vs. Free Allowances over Time
Source: Pewclimate.org

Offsets

ACES would incentivize a variety of GHG-reducing activities by allowing “offset” credits to be issued for each ton of CO₂e reduced or avoided by qualifying projects. EPA would establish an offset program addressing a range of issues such as “additionality,” baselines, quantification and verification, and “leakage.” (See A+B Glossary of Key Terms). Examples of projects EPA might authorize include energy switching projects, HFC or methane destruction projects, or certain energy efficiency projects. A key point: to qualify, an offset credit from an existing or new project must be issued after January 1, 2009.

A separate offset program for agricultural and forestry activities would be administered by the Department of Agriculture. Qualifying projects would include altered tillage projects; reduction in nitrogen fertilizer use; afforestation; reforestation; manure management; and many others.

ACES also includes mechanisms designed to allow the swapping out of international allowances and credits such as those recognized under the Kyoto Protocol, and certain regional allowances and credits.

Regulated and non-regulated entities need to pay attention to the development of “offset” programs, because qualifying projects have the potential to generate a substantial return on investment.

Market Program Operations

ACES allows for trading, banking, and limited “borrowing” from future years, of emission allowances. An allowance established under the Act can be conveyed until (i) retired, or (ii) extinguished by EPA for specified reasons. Similarly, emission allowances have the same compliance value in any year following the year in which they were issued, although their monetary value may vary substantially over time.

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