

# **FEDERAL CLIMATE CHANGE LEGISLATION OUTLOOK AND ISSUES**

## **AIR QUALITY REGULATION IN THE PACIFIC NORTHWEST Greenhouse Gases, Stationary & Mobile Source Emissions, and the Emerging Biofuels Industry**

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Burning fossil fuel for light, heat and energy has been part of our society for hundreds of years. Indeed, in some ways our society's increased use of fossil fuels has been a barometer of our well being. It has enabled Americans to live in centrally heated and cooled homes, drive wherever we want to, and jet across the country and around the world.

Regulating and reducing the emission of greenhouse gases (GHG) runs directly counter to the longstanding trend of increased energy use in the U.S. and the world. Unless we can quickly and economically figure out a way to sequester carbon, climate regulation will likely require us to use less energy. That would present a fundamental change in our society. A climate change regulatory regime will have societal impacts that are far more extensive and wide ranging than those that resulted from the environmental law revolution associated with the enactment of the Clean Air Act, Clean Water Act, Endangered Species Act and other landmark environmental statutes. Consequently, it will be a difficult issue for our political system to address.

My remarks today will focus on the outlook for the enactment of federal legislation to regulate GHG emissions and then move on to the key regulatory issues being considered by Congress.

## **I. LEGISLATIVE OUTLOOK**

### **How likely is it that Congress will enact legislation to regulate and reduce the emissions of GHG?**

Very likely, in my opinion. There are many reasons that Congress will act, including:

- Growing scientific and public consensus.
- Groundswell of support from many emitters, including energy utilities, the auto industry, manufacturers, retailers, labor and others.
- Growing international pressure.

An odd situation has arisen where the Bush Administration is currently positioned to the right of many, if not most, in industry on the climate issue. Notwithstanding the increasingly marginal nature of their position, the Administration continues to oppose mandatory controls on GHG emissions. Industry has largely abandoned the Bush Administration for two reasons: 1) they see climate as a moral issue and want to be on the right side; 2) they are concerned that if they continue to oppose climate legislation they won't have any influence over the hundreds of important details in whatever law gets enacted. No one wants to be standing on the platform when the climate legislative train pulls out of the station.

### **When will federal legislation to control GHG emissions pass?**

With the advent of the Democratic Congress in January of this year, the level of legislative activity on climate change skyrocketed. It seems that every week there is another Congressional hearing or bill being introduced on some aspect of the climate change issue. Nevertheless, although substantial progress is being made, the likelihood of federal climate change regulatory legislation being signed into law during this Congress is low for many reasons, including:

- Need for 60 votes in the Senate.
- Bush Administration opposition.
- Complexity of the issue.

Notwithstanding these hurdles, much of the foundation for the legislation that is ultimately enacted will likely be built during this Congress.

It is not clear at this time which body of Congress will move first on a climate regulatory bill. At the moment, the Senate Environment Committee, Chaired by Senator Boxer, appears to be in the lead because of a compromise cap and trade proposal being developed by Senators Lieberman and Warner. Both of these Senators serve on the Environment Committee.

Since Senator Warner, a prominent Republican, moved from opposing mandatory GHG controls to supporting controls, there is now a clear majority in the Environment Committee for mandatory controls, notwithstanding the past statements of the ranking Republican member of the Committee, Senator James Inhofe, that climate change is a hoax. Assuming that the Democrats and Independents (Senators Lieberman and Sanders), and two Republicans, Senators Warner and Alexander, band together that results in a decisive 12-7 majority in favor of mandatory controls on the Senate Environment Committee.

#### **What kind of bill, if any, can get out of the Senate Environment Committee?**

Hard to say. For example, the Senators in favor of mandatory controls could split on issues such as the rate of carbon reductions, with some pushing for very deep cuts and others taking a more moderate approach. Disputes over how to allocate allowances to emit GHG are also likely. Notwithstanding these thorny issues, there is a reasonable chance that climate legislation will be reported out by the Senate Environment Committee as early as this fall. Even if the legislation went no further once it hit the Senate floor, this would be a major achievement. At that point, negotiations might begin with a wide range of Senators, including the Chairman of the Senate Energy Committee, Senator Bingaman, who has introduced his own climate change bill, which is more moderate than any bill that is likely to emerge from the Senate Environment Committee.

#### **What about the House of Representatives?**

The legislative outlook in the House of Representatives is even more unclear than the Senate. Speaker Pelosi and many other members of the Democratic caucus want a climate regulatory bill to pass this Congress. As part of that effort, the Speaker formed the Select Committee on Global Warming, chaired by an ally, Representative Markey. However, the legislative jurisdiction over the climate issue remains with the venerable Chairman of the House Committee on Energy and Commerce, Representative John Dingell, and he is sending out mixed signals regarding his intentions. At the same time, the Chairman of the Commerce Subcommittee on Energy and Air Quality, Rep. Boucher, has recently stated that he is ready to get moving on climate legislation. In the end, some type of accommodation can and must be reached between Speaker Pelosi and Chairman Dingell for legislation to move through the Commerce Committee and the House floor.

## **How will the 2008 election impact federal regulation of GHG emissions?**

What is likely to put a federal climate change regulatory statute over the finish line is a new President taking office in January 2009. Regardless of whether a Democrat or a Republican is our next President, there is a good chance the next President will support enactment of some type of regulatory scheme regarding GHG emissions.<sup>1</sup> In turn, Congress is likely to enact such legislation sometime during the next Presidential term.

Indeed, it is possible that the odds of passage could be higher with a Republican President because it would be harder for Congressional Republicans to frame the climate issue as a partisan one as they did during the Clinton-Gore Administration. Therefore, within two to four years, we are more likely than not to have regulation of GHG emissions as the law of the land. Assuming legislation is enacted in 2010, implementation of carbon trading would likely begin in 2012/2013.

## **II. REGULATORY ISSUES<sup>2</sup>**

### **Issue No. 1: How much GHG reduction is necessary, and how soon?**

From a political perspective, the question of whether climate change is real and caused by human activity has been answered (yes). Unless and until dramatic new evidence comes to light, most federal legislators will assume that the future well-being of Americans, and everyone else, depends on slowing and ultimately reversing rises in atmospheric concentrations of GHGs. Any doubts that remain pertain to how serious the problem is, how much time we have to solve it, and therefore how radical the solution must be. Some of the key questions are:

- How much of an increase in energy costs can the economy tolerate?
- What are the economic consequences of unchecked climate change?
- Is there an environmental “tipping point”, a point at which the effects of climate change either dramatically accelerate and/or become irreversible?

In light of these questions, there is substantial variation in the aggressiveness of the bills that have been introduced.<sup>3</sup> In the Senate, the most aggressive bill, S. 309 (introduced by Senators Sanders, Boxer, and others) requires that GHG emissions be reduced by 2050 to 80% below 1990 levels. At the other end of the spectrum, S. 1766 offered by Senators Bingaman and Specter would reduce carbon emissions to 1990 levels by 2030.

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<sup>1</sup> All of the Democratic Presidential front-runners and Senator McCain support mandatory GHG controls. A check of the websites for Republican candidates Romney and Giuliani turned up no position papers to date on climate change from these candidates. President Bush supported mandatory controls on GHG in 2000 general election, but reversed course once he took office.

<sup>2</sup> Most of the discussion in this section is from an article in the July 2007 edition of “Power” magazine, “The Bumpy Road to Federal CO<sub>2</sub> Caps” by Craig Gannett and Dan Adamson, Davis Wright Tremaine LLP.

<sup>3</sup> For the sake of simplicity, this paper discusses legislation introduced in the Senate. In most cases, companion legislation to the various Senate bills has been introduced in the House.

Other Senate bills plot a course somewhere between these two poles. The estimated effect of S. 280 (introduced by Senators McCain, Lieberman, and others) would be a reduction in emissions of about 60% below 1990 levels by 2050. Meanwhile, S. 317 (introduced by Senators Feinstein and Carper) would reduce emissions by about 40% below 1990 levels by 2050. By comparison, the Kyoto Protocol was intended to reduce GHG emissions 7% below 1990 levels by 2012. In other words, all but the most modest bill would far outstrip the reduction goals of the Kyoto Protocol, but over a much longer period of time.

### **Issue No. 2: Cap and trade vs. carbon tax?**

Two mechanisms have been proposed for reducing GHG emissions, a cap and trade system or a tax. Under a cap and trade system allowances to emit GHG will be issued by the federal regulator every year. Entities that emit GHG will then be responsible for submitting to the regulator enough allowances to cover their emissions. The number of allowances will be reduced every year, until GHG reduction goals are met. Under a cap and trade system emitters are free to take the most cost-effective path by either reducing their own emissions or paying for the right to emit by obtaining an allowance.

The other approach to GHG reduction is some type of GHG or carbon tax. Emitters would seek to reduce their emissions in response to the tax, which would have to be adjusted periodically to achieve the desired reductions.

While there are respected industry leaders and economists that support a carbon tax, cap and trade appears to have won the debate for two reasons, one based on policy, the other based on politics:

- A carbon tax doesn't provide assurance that emissions goals will be achieved.
- Taxes are political poison.

### **Issue No. 3: Which sectors of the economy should be regulated?**

Once Congress determines how much and how soon GHG emissions should be reduced, the next question is the scope of the regulation necessary to achieve those goals. Key sectors include:

- Electricity production
- Transportation.
- Industrial/manufacturing.
- Commercial buildings and activities.
- Residential buildings and activities.
- Agriculture.

Another question is how to share the pain. For example, GHG reduction could be achieved by imposing a cap-and-trade program on power plants, by raising Corporate Average Fuel Economy (CAFE) standards, or by mandating more-efficient residential electrical appliances.

Among the pending bills, the Bingaman-Specter and the McCain-Lieberman and Sanders-Boxer bills are economy wide in scope. Although the Feinstein bill targets only power generation, Senator Feinstein has pledged to introduce additional bills to cover the other sectors.

**Issue No. 4: Where in the energy supply chain should GHG emissions be regulated?**

One camp would regulate emissions “upstream” in the energy supply chain; for example, at the wellhead and mine mouth. Using this approach, producers of fossil fuels would be responsible for submitting emission allowances to the regulatory agency. Others favor a more “downstream” point of regulation, such as at the level of electric generation facilities.

The main advantage of the upstream approach is that it facilitates regulation of all sectors of the economy by imposing caps on a relatively small number of entities. On the other hand, advocates of downstream regulation worry that placing the regulatory obligation upstream could obscure the price signals that will be needed to change the behaviors that cause GHG emissions.

At this point, it appears that a consensus is growing for an upstream point of regulation for oil and natural gas and a downstream point of regulation for coal at the combustion stage (power plant or boiler).

**Issue No. 5: How should the burden of GHG reduction be shared within the electricity sector?**

This question pertains to how to distribute the burden of CO<sub>2</sub> reduction within each sector. For example, for the transportation sector, should a mandated increase in fuel efficiency be the same for heavy trucks as for hybrid cars? For the power generation sector, this is an extremely important question.

The fairness of the approach will depend in large part on the method used to allocate initial GHG emissions allowances. Allowances could be distributed based on a number of different factors. One approach is the allocation of allowances based on historic CO<sub>2</sub> emissions. This is the approach generally taken in the Bingaman-Specter bill. Under this approach, fossil generators would receive a large number of highly valuable allowances that they could either use to cover their own emissions or to sell to others who need them. Utilities that rely primarily on fossil-generation tend to favor this approach. Their position is that they need the benefit of these valuable allowances to help offset the costs of reducing their emissions. On the other hand, low-emission generators tend to oppose emission-based allocation because it rewards utilities that own and operate old and inefficient coal-fired plants and penalizes those who have invested in non-emitting or low-emission generation.

Another approach to allocating allowances to emit GHGs is to do so based on electricity output. Under this method, the available allowances would be distributed to generators in proportion to the amount of electricity they produce. Consequently, all types of generation, including non-emitting generation such as hydro, wind, and nuclear, would receive allowances. This “output” based allocation would reward entities that have invested in low-emission generation and also

serve to encourage investment in new non-emitting generation. This is the allowance allocation approach taken in bills introduced by Senators Feinstein and Carper.

There is also discussion about allocating allowances to local electric distribution utilities based on the amount of load they serve. The benefit of this approach is that it could be structured to assure that the benefits of valuable allowances would go to retail customers or serve other important public purposes as determined by a state public utility commission or locally elected board. This is an approach that the CEO of Exelon, John Rowe, has raised in a number of different forums. It may appeal to some policy makers that believe that allowance allocation to generators, based on either historic emissions or electricity output, is not the way to go.

A final approach to allowance allocation is auction. In other words, sell all allowances to the highest bidder. One aspect of this approach that may appeal to policy makers is that it can be used to create a very large revenue stream that can be devoted to tax reduction in other areas or climate related needs such as R&D on non-emitting generation and carbon sequestration. The Bingaman, Feinstein and Carper bills in the Senate all provide for a gradually increasing amount of allowances to be auctioned over time. Interestingly, skipping ahead to regional issues, the Northeast States involved in the “RGGI” program have chosen to auction all allowances.

#### **Issue No. 6: Should there be a “safety valve” to provide cost certainty?**

One key feature of the Bingaman-Specter bill is that it contains a “safety valve” that may be exercised should the price of allowances become too high. Following the recommendation of the National Commission on Energy Policy, the Bingaman-Specter bill allows a regulated entity to purchase allowances from the federal government for \$12 per ton in the first year, with the price rising in each of subsequent years.

This safety value would give emitters cost certainty, no matter how haywire the allowance market becomes or how technologically difficult complying with the declining GHG cap proves. In other words, it assures them of the availability of credits at a relatively modest price. On the other hand, many environmentalists are concerned that a safety valve would keep the price of carbon too low and thus discourage investments in emission reduction technologies.

#### **Issue No. 7: What compliance options should exist?**

A generator would have two obvious ways to comply with a carbon cap: reduce the GHG emissions from its facilities after enactment of the cap, or purchase or otherwise obtain allowances. However, the pending climate-change bills provide several other compliance options.

For example, several bills allow regulated entities to receive credits for GHG reduction efforts undertaken before the cap came into effect. The McCain-Lieberman bill provides credit for certain GHG reduction efforts initiated since 1990.

As another example, all of the bills allow regulated entities to satisfy at least some of their obligations by submitting “offsets” from a project to reduce GHG emissions in other nations, if the project meets certain criteria.

**Issue No. 8: What is the appropriate role of the states in a cap and trade system?**

Defining the appropriate role of the states in GHG reduction efforts is likely to be contentious. In the absence of a federal cap-and-trade program, states are acting on their own and also banding together in an effort to create regional programs. Assuming that these state and regional programs become a reality before Congress acts, what should happen to them once it does? Will it be possible to reconcile the requirements of a state, regional and federal program, or will preemption be necessary to avoid duplication and inconsistent requirements?

The Bingaman-Specter bill is silent on whether states may have their own cap-and-trade program, but the Feinstein-Carper bill appears to allow states to continue operating their own cap-and-trade system after a federal trading system is in place. The McCain-Lieberman bill authorizes states to require additional emission reductions, but it does not clearly state whether the additional emission reductions can be achieved through a cap-and-trade program.

**Issue No. 9: How can America’s and others’ GHG reduction efforts be reconciled?**

Perhaps the most important goal for this Congress—and the next Congress and administration—is obtaining the support and cooperation of developing nations in pursuit of a substantial worldwide reduction in GHG emissions. Without an effective international strategy that includes the participation of China and India, the sacrifices imposed by domestic U.S. legislation will likely be in vain. China derives almost 70% of its electricity from coal, and may have already surpassed the U.S. as the current leading emitter of GHGs (however, US historic total emissions far outstrip China’s). India, with its fast-growing economy and ample coal reserves, is not far behind.

Consequently, if the U.S. adopts and achieves massive cuts in GHG emissions but the rest of the world does not follow, the legislation could address this disparity by relaxing U.S. limits. Conversely, if the rest of the world achieves reductions at a much faster pace than expected, it might be appropriate for the U.S. to accelerate its program to reduce emissions as well.

**III. CONCLUSION**

The climate change issue will test the ability of the federal government to address and solve a major problem. Let’s all hope that in the end, Congress and the Executive Branch show their best side when tackling the climate change problem and enact and implement a sensible and effective climate change regulatory system that goes a long way toward solving the climate change dilemma. As has often been the case throughout history, political leadership will be the key to success. A President with leadership qualities akin to Winston Churchill’s would certainly be helpful.