

CALIFORNIA STILL HAS MUCH TO DECIDE BEFORE ITS CAP-AND-TRADE SCHEME CAN START IN 2012. **RORY CARROLL** REPORTS

# California dreamin'?

**C**alifornia, the largest and arguably most progressive state in the US, recently embarked on a two-year process to develop the rules for its ambitious greenhouse gas (GHG) reduction law.

But, after a lengthy battle over the state budget deficit of over \$42 billion, intense partisan gridlock at the state capitol, and expected legal challenges to the programme, some observers are wondering whether California's grand plan will ever get off the ground.

Despite the many challenges, state officials, led by California Governor Arnold Schwarzenegger, are forging ahead with the plan, firm in their belief that it will create jobs and give the state's beleaguered economy a much needed boost.

The initial law, signed by Schwarzenegger in 2006, requires the state to cut GHG emissions to 1990 levels by 2020, a 30 per cent decrease. That would require a reduction of about 169 million tonnes of carbon dioxide equivalent per year. After that, the state intends to cut emissions 80 per cent below 1990 levels by 2050.

Some believe the state is setting itself up for failure, and that the targets simply aren't realistic.

"Many of us in the legislature believe that the requirement to reduce greenhouse gas emissions to 1990 levels by the year 2020 is too ambitious," said California state Senator Dave Cox.

Proponents argue that the reduction is guided by science, and note that California will face shrinking coastlines and droughts if climate change continues unchecked.

The state's Air Resources Board (Carb) is charged with the task of designing and implementing a plan to meet the goal. It is chaired by Mary Nichols, a former official in the administration of Bill Clinton, and who still has close ties to key members of Congress.

In mid-December, Carb unanimously approved the plan after an 18-month public process.

Among the elements included in the plan is California's participation in a regional cap-and-trade programme, a requirement that the state produce a third of its electricity from renewable sources by 2020, and a boost in vehicle emissions standards beyond that required by the federal government.

And, while hailed by many as a milestone, the document

leaves many questions unanswered. Nichols said it would provide direction.

The vote marked the beginning of the rulemaking process for the plan, where many of the more controversial issues, such as allocation of allowances and the use of offsets, must be sorted out.

The next big document from Carb, which should answer some key questions, is expected in December.

"We're looking forward to an intense two years of developing the rules and regulations that will get us to our goal with full public input," said Stanley Young, a spokesman for Carb.

"We're at the beginning of the process," said Josh Margolis co-chief executive officer of environmental broker CantorCO2e in San Francisco. "We've all walked out on the dance floor and we're sizing each other up," he said.

The plan's central feature is a cap-and-trade scheme covering 85 per cent of the state's emissions.

Carb must adopt the emissions trading regulations by 1 January, 2011, and the programme must begin in 2012. The first allowance auction is also expected to take place in January 2011, said a source close to the rulemaking.

The scheme is not supposed to be a California-only system. The state hopes to trade with other states and Canadian provinces that are members of the Western Climate Initiative (WCI) – a multi-sector cap-and-trade scheme consisting of seven US states and four Canadian provinces.

But that may also be problematic. To enroll in the WCI, states only needed a green light from their governor.

But to actually participate in the WCI when it begins trading in 2012, individual state legislatures need to approve enabling legislation. Political experts believe that several states, including Arizona, New Mexico, Montana and Utah, are unlikely to do so, especially if the economy doesn't improve.

Many believe only California, Oregon, Washington and the four Canadian provinces – British Columbia, Manitoba, Ontario and Quebec – will be ready to trade in 2012, with the other states watching from the sidelines.

The fewer states that participate, the less liquid the market, traders and brokers note. That increases the likelihood of price volatility and unpredictability.

One highly contentious issue Carb will have to decide is how to distribute allowances.

The WCI mandates that at least 10 per cent of all allowances be sold to polluters at the first auction. It gives

states the right to raise that percentage if they like. WCI officials have said they plan to move quickly to a full auction.

Los Angeles Department of Water and Power, the largest municipal utility in the country that serves the hot and dry region around LA, has argued fervently for free allowances, and said it will continue to do so during the rulemaking process.

Environmentalists argue that the allowances must be sold so that the state isn't just giving free money to covered entities, reducing their incentive to change their business practice.

What percentage Carb ultimately decides upon is anybody's guess, sources said, but it will almost certainly leave somebody cold.

Carb is expected to have the cap-and-trade regulations worked out sometime between May and July of 2010.

What carbon offsets to allow in the system, and how many, is another difficult issue Carb will have to tackle. But it is wasting no time addressing the topic.

Carb's current plan limits the use of offsets and allowances from other emissions trading systems to 49 per cent of the state's required emissions reductions. But that could change.

In March and April, Carb will hold formal meetings examining offset limits, the definition of an offset, and how many international offsets to allow in the programme.

Neither meeting is expected to lead to immediate conclusions, but could provide an idea of where Carb is headed.

"The fact that they are focusing on that so early is a good sign that they want to meet their overall timeline," said Aleka Seville, manager of communications and marketing at environmental consultancy First Climate in San Francisco.

One tricky question is how to treat forestry offsets. Despite the EU's well known distaste for carbon credits from afforestation and reforestation (A&R) projects in its trading scheme, many WCI members, including California, are likely to push for inclusion of a variety of forestry offsets. The WCI members



will consider credits for avoided deforestation and A&R.

Doing so could present difficulties if the WCI tries to link with the European trading system, some have said.

"I'm confident that Carb is moving forward in the mindset of linking up not only with a national scheme, but with an international scheme," Seville said. "It'll probably be a bit messy, but I do think they'll be incorporated once the US participates internationally, because they are going to play such an important role in California and in the WCI."

What to do with revenue generated from the programme is another issue Carb must wrestle with.

"They'll have to decide what to do with a multi-million dollar revenue stream coming in, and protecting that from other competing revenue demands," Cantor CO2e's Margolis said. "If that money is not protected, it's going to make more difficult our challenge to meet the goals, and more expensive," he said.

The current plan suggests that the revenue will go towards energy efficiency and renewables, as well as helping ratepayers cope with higher utility bills, among other things.

But, once again, it will be up to Carb to decide how to distribute the money. And there is still opposition to California's plan to be dealt with.

Environmental activists have staged several disruptive protests at Carb meetings, arguing that the cap-and-trade programme will merely enrich polluters, while doing nothing to help the environment. However, the plan does enjoy the strong support of some environmental groups, such as the Natural Resources Defense Fund.

Some of the state's more conservative lawmakers have indicated that they will work hard to block the plan. One Republican party member in the state House has even introduced a bill that would negate the original legislation. But this bill is not expected to move out of committee.

During recent negotiations over the state's huge budget deficit in early February, Republicans tried to force Democrats and the governor to trade environmental regulations in return for budget compromises.

State environmentalists cried foul, saying that those regulations, like the emissions reduction plan, have no impact on the immediate budget.

After a lengthy battle, Republican attempts to weaken the plan were fended off. The budget, which closed the state's \$42 billion shortfall, achieved balance through steep spending cuts, borrowing, and new taxes.

But the Republican attempt sends a signal that they will fight against cap-and-trade.

But Republican opposition is just one issue. Covered entities like utility companies and manufacturers are likely to take legal action once Carb begins adopting regulations.

"Without a realistic assessment of the impact that the (plan) will have on existing jobs in California, the California Chamber of Commerce is certain that the state is headed down a path that will slow economic recovery and delay a long-term solution to the budget crisis," said Amisha Patel, a policy advocate for the Chamber.

While no suits have been filed yet, it is expected that opponents will be well positioned since so much of the regulation is being done through rulemaking, as opposed to having the details approved in legislation.



## California Governor Arnold Schwarzenegger signed the original law in 2006

Carb officials have already said they are expecting suits, and will be prepared.

Both proponents and objectors will be watching carefully for economic impact studies. Some that have been completed have reached contradictory conclusions.

A Carb study found that the plan would grow the state's economy. A peer review of the study challenged that assertion, however, saying that Carb had been too positive in its assessment. Carb's Young said that more economic analysis will be conducted in the future.

One likely scenario is that California and its regional partners will be absorbed into a national trading scheme.

President Barack Obama favours a national cap-and-trade programme, as do many state governors (see pages 22–23).

But that will require federal legislation, and previous attempts have failed. There are still reasons to believe that proponents are still far from the 60 votes they need to pass the legislation in the Senate in 2009 or perhaps even 2010.

Interestingly, however, nearly all the key politicians in Washington DC on cap-and-trade are from California.

The Senate bill is expected to be worked out in the environment and public works committee, which is chaired by California Democrat Barbara Boxer. She has indicated that she might want to follow the "California approach" to cutting emissions in her cap-and-trade bill.

The House of Representatives bill will be worked out in the energy and commerce committee, which is now chaired by California Democrat Henry Waxman. The Speaker of the House, who decides how quickly a bill moves to the floor for a vote, is California Democrat Nancy Pelosi.

Having those people in such prominent positions bodes well for California, which has made certain demands about what it needs before it will agree to give up its plan for participation in a national scheme.

Chief among those demands are that it be allowed to keep its targets if a national plan sets weaker goals, and that it receive "early action credits" for the work it has already done.

That essentially means federal money, and given its giant budget deficit, any funds are welcome.

"We will be better off in a carbon-restrained economy," said CantorCO2e's Margolis. "But it's going to take some fine stepping to ensure that we get there in one piece." ●