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Climate Change Policy & Carbon Finance

Legislative UPDATE

The Prospects for Climate Change Regulation

"My presidency will mark a new chapter in America's leadership on climate change that will strengthen our security and create millions of new jobs in the process. That will start with a federal cap and trade system."

President-elect Barack H. Obama - Nov. 18, 2008

For those who thought an Obama administration would put off taking action on carbon policy in times of economic and financial crisis, think again. President-elect Obama's post-election statements indicate that making a dramatic shift in U.S. policy on climate change is one of his first priorities. With the benefit of Democratic Party majorities in both houses of Congress, President-elect Obama is set to take aggressive steps to regulate carbon dioxide ("CO_2") and other greenhouse gases ("GHGs") domestically and to resume a leadership role in global negotiations. In short, the train has left the station. There will be federal climate change regulation. The remaining questions, therefore, are how soon will that train arrive and in what form?

What sectors of the economy will ultimately be considered covered (i.e. regulated) entities? What parameters and limitations will the federal scheme place on a mandatory carbon market? Will the view that a slow transition to a low-carbon economy is necessary prevail over the need to take urgent action to mitigate the effects of climate change? Will an Obama administration seek to link development of a federal U.S. system with a post-2012 global carbon market?

Will Federal Climate Change Regulation Arrive in 2009?

Because of the enormity of the undertaking, we believe it unlikely that climate change regulation will be enacted in 2009. It could even be years before a federal carbon market is fully designed and implemented. Overcoming the complex policy and political hurdles will take time.

It remains unclear how an Obama administration will tactically approach carbon policy and legislative development. It is also unresolved how much Congress will cooperate with the Obama administration. Members in the Senate and House have been seriously debating the issue for years and have their own views about what federal climate change legislation should include. Different sectors of the economy and regions of the country also have divergent and often conflicting interests that will increasingly complicate carbon politics. A federal carbon market will produce *bona fide*

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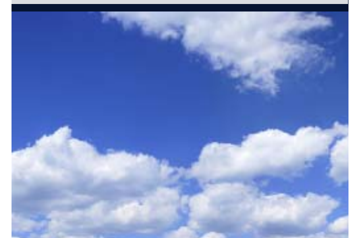

winners and losers. Determining which entities are which will depend on the design, scope and parameters of the federal regulatory regime.

President-elect Obama's Initial Position

President-elect Obama's starting position for debate is introduction of an economy-wide cap-and-trade program that seeks to reduce GHG emissions to 80 percent below 1990 levels by 2050. All emission allowances (i.e. carbon credits) would be auctioned, with the proceeds directed into clean technology development and deployment. If implemented, Obama's plan would require no less than a fundamental transformation of our entire economy. Everything we do now from how we generate and consume energy to how we live and travel, will need to be done completely differently in just four decades. The sweeping scale of such redirection is at the core of President-elect Obama's objective of initiating a "green" economic recovery.

Other possible climate change-related initiatives include:

- appointment of a federal "Climate Change Czar" tasked with overseeing integration of the administration's carbon policy and energy objectives into the policies, practices and regulations of federal agencies;
- continuing to pursue and fund development of clean coal technology and Carbon Capture and Sequestration;
- investing $150 billion over 10 years in low-carbon advanced energy technologies;
- establishing a federal Renewable Portfolio Standard that mandates that public utilities achieve 10 percent of US electricity supply from renewable sources by 2012, and up to 25 percent by 2025;
- re-engaging with the United Nations Framework Convention on Climate Change on the future for multilateral agreement on global efforts to address climate change after the expiration of the Kyoto Protocol in 2012;
- extending the federal Production Tax Credit for certain types of renewable energy by five years; and
- establishing a national low carbon fuel standard that aims to reduce the carbon content of transportation fuels by five percent by 2015 and 10 percent by 2020 through incentivizing low-carbon, non-petroleum fuels.

Expectations for the 111th Congress

While the Obama administration will want Congress to get to work on its cap-and-trade proposal, legislators on Capitol Hill have already indicated it won't be that easy. There are early indications that the House and the Senate will be debating a number of different proposals.

"Politically, scientifically, legally, and morally, the question has been settled: regulation of greenhouse gases in the United States is coming. We believe that elected and accountable representatives in the Congress, not the Executive Branch, should properly design that regulatory program. The only remaining question is what form that regulation will take."

Chairman Rick Boucher, Subcommittee on Energy and Air Quality and Chairman John Dingell, Committee on Energy and Commerce - Oct. 7, 2008

The House, for example, had expected to debate in earnest its own cap-and-trade proposal first thing in 2009. Energy and Commerce Committee Chairman John Dingell (D-Mich.) and Subcommittee on Energy and Air Quality Chairman Rick Boucher (D-Va.) had released draft legislation in early October 2008 that was to set the parameters for House debate. The draft Dingell-Boucher legislation won high marks from outside observers as a tough but pragmatic solution.

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The fate of that draft legislation is up in the air, however, now that Rep. Henry Waxman (D-Calif.) has ousted Dingell from the Energy and Commerce Committee chairmanship. The Committee could start with an entirely different package. Congressman Waxman may even seek to introduce and debate Obama's plan. This possibility appears likely because the Obama transition team has named Phil Schiliero (former Chief of Staff to Rep. Waxman) as Obama's director of legislative affairs.

The Senate, on the other hand, could be the political wild card in 2009. Last year, America's Climate Security Act of 2007 (known as the "Lieberman-Warner" bill) was developed and brought to the floor, only to be withdrawn due to procedural and political hurdles that halted debate. It is expected that Sen. Barbara Boxer (D-Calif.) will introduce "streamlined" legislation, but competing bills could be introduced by Sen. Jeff Bingaman (D-N.M.) and even Sen. John McCain (R-Ariz.). Major policy issues to focus on in the Senate debate will be (1) emissions allowance allocation vs. auctioning, (2) offset eligibility, (3) safety valves versus banking and borrowing, (4) early action credit, and (5) federal pre-emption.

A fourth scenario to closely monitor in the event of prolonged legislative horse trading will be whether the Obama administration uses EPA's regulatory authority to institute some form of CO_2 regulation in advance of new congressional action on a cap-and-trade proposal. In June 2008, EPA released an Advanced Notice of Proposed Rulemaking in response to the landmark Supreme Court ruling that confirmed EPA's authority to regulate CO_2 under the Clean Air Act.

Coordination with the States

In the absence of federal climate change leadership and regulation over the past eight years, individual states and regions have taken action to fill the void.

Recent highlights include:

- The Virginia Commission on Climate Change, appointed by Gov. Tim Kaine, voted in November to recommend that the Commonwealth reduce its GHG emissions to 25 percent below business as usual levels by 2020, and 80 percent by 2050. The Commission has until December 15 to submit a final recommendation report to Governor Kaine.
- Also in November 2008, 26 leaders from states in Brazil, Canada, China, India, Mexico, and the United States signed an agreement under which the signatories will cooperate in reducing GHG emissions and share best practices and technologies to reduce emissions.
- In September 2008, the first auction of emissions allowances under the Regional Greenhouse Gas Initiative (known as "RGGI") took place. The next auction is scheduled for December 2008.
- Also in September 2008, the Western Climate Initiative (known as "WCI") released the second draft of a regional cap-and-trade program.
- In January 2009, the California Air Resources Board is set to submit for approval its "Final Scoping Plan" to recommend that the California legislature institute market-based GHG programs (including statewide cap-and-trade) and renewable energy initiatives.

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The progress of GHG policies at the state level now poses a legitimate dilemma for federal policymakers, primarily on the issue of whether the programs should be preempted or integrated into a federal carbon market. Rep. Waxman and Sen. Boxer are from the state of California and both strongly oppose preemption. These and other issues will compound existing carbon policy disagreements in 2009.

Bottom Line: How Do Companies Prepare and Take Advantage?

Business entities should prepare for the implementation of a federal cap-and-trade regime, if they haven't already done so. Preparation can take several forms, depending on the particular sector or the carbon intensity of the company's product or operations.

To start, figure out whether your company or entity is likely to be regulated. Next, a climate-change risk strategy should be developed. Conduct a full carbon inventory to assess the company's risk exposure. Then, identify GHG emissions reduction or offset opportunities (e.g. direct reductions, supply chain management and energy efficiency measures). Of course, you must also estimate how much each of these measures will cost. The financial due diligence should evaluate the marginal emissions abatement costs in two different contexts.

First, the potential capital or investment costs should be viewed in terms of current and future carbon market value. If a company can generate revenues now by taking advantage of voluntary or regional carbon markets, those factors should be carefully considered and explored. Second, the potential costs should be integrated into the company's overall long-term carbon risk management objective, which requires forecasting what the company's regulatory obligations will be under the parameters of the prospective federal carbon market scheme, and what additional costs the company may incur if it does not take early action.

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For more information on possible climate change policy and regulatory developments or questions on how to prepare your company, please contact William A. Anderson, II, wanderson@williamsmullen, or Cameron Prell, cprell@williamsmullen.com, 202.833.9200.