

## **SENATORS UNVEIL CLIMATE CHANGE AND ENERGY LEGISLATION**

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To Our Clients and Friends:

After months of intense negotiations and discussions with various industry and environmental groups, a draft Senate climate change and energy bill has been released to the public. On May 12, 2010, Senators John Kerry (D-Mass.) and Joseph Lieberman (I-Conn.) circulated a discussion draft of the American Power Act (the “APA”). The draft legislation, which has not yet been formally introduced in the Senate, includes a cap on greenhouse gas (“GHG”) emissions from sources including electric utilities, industrial operations and transportation fuels. The bill also provides for offshore drilling for oil and gas, encourages development of nuclear energy and funds research of alternative sources of energy.

Proponents of a climate change and energy bill have been eagerly awaiting action in the U.S. Senate since last summer, when the U.S. House of Representatives passed a climate change and energy bill, the American Clean Energy and Security Act of 2009 (“ACES”). However, with the Senate focused on healthcare reform legislation, efforts to push forward with a climate change bill stalled. Now that the draft APA has been released, the Senate’s attention may shift back to climate change and energy legislation.

### **HIGHLIGHTS OF THE PROPOSED LEGISLATION**

The APA aims to reduce U.S. GHG emissions 4.75% below 2005 levels by 2013, 17% by 2020, 42% by 2030, and 83% by 2050. ACES set slightly different short-term GHG emissions reduction goals – calling for reductions of 3% from 2005 levels by 2012 and 20% by 2020 – but has the same targets for 2030 and beyond. Unlike ACES, the APA employs a sector-specific approach to achieving its GHG reduction targets by proposing separate mechanisms for power plants, heavy industry and transportation.

#### **Cap-and-Trade**

To help meet its emissions reductions goals, the APA would establish a nationwide cap-and-trade program, capping emissions from approximately 7,500 major sources of GHG emissions. Each entity covered by the cap would be required to surrender allowances each year. Each allowance would represent the ability to emit the equivalent of one ton of carbon dioxide or its GHG equivalent over the previous year. Initially, the APA would provide free allowances to entities subject to regulation to ease the transition to the new regulatory regime. Free allowances would be fully phased out so that auctions would be the only source of allowances by 2030.

The cap-and-trade system for electric utilities would begin in 2013. For large natural gas local distribution companies and industrial sources emitting more than 25,000 tons of carbon dioxide equivalent pollution annually, the system would begin in 2016.

**Cost Controls.** To assist regulated entities in forecasting compliance costs, the bill sets a price floor of \$12 per ton and a price ceiling of \$25 per ton. The floor price would rise by 3% annually over inflation and the ceiling price would increase by 5% annually over inflation. Some are concerned that this “price collar” provision would render the cap-and-trade system ineffective in reducing actual emissions because it would distort the market price and fail to put a high enough cost on compliance. Others note that the price collar mechanism could make it difficult to integrate the U.S. into a global cap-and-trade regime.

**Offsets.** The draft legislation permits those entities subject to cap-and-trade regulation to use domestic and international offsets to comply with the emissions cap. Offsets are GHG emission reductions achieved by a source that is not subject to a cap. Under the APA, offsets can only be issued with respect to GHG emissions reductions that are measurable, verifiable, enforceable and additional to what would be achieved in a business-as-usual scenario. Foreign and domestic offsets would be regulated by the U.S. Environmental Protection Agency (the “EPA”) and, with respect to the agricultural sector, the U.S. Department of Agriculture (“USDA”), and would be recorded in a central registry. The APA includes an initial list of eligible domestic offset project types, ranging from methane recapture to forest management, with additional project types to be determined by the EPA and USDA. Offsets not to exceed two billion tons of GHGs annually could be used to demonstrate compliance.

**Pre-Compliance.** U.S. businesses would be rewarded for pre-compliance measures, with the EPA awarding allowances in return for offsets issued or GHG emissions reductions achieved prior to 2009. The APA charges the EPA with determining what offset types and reductions would be eligible for allowances.

**Market Regulation.** The APA would amend the Commodity Exchange Act (7 U.S.C. §§ 1-27f (1936)) to provide for the Commodity Futures Trading Commission (the “CFTC”) to oversee the trading of GHG instruments. Participation in auctions and primary cash markets would be restricted to entities with compliance obligations and a limited number of “market makers.” Trading in secondary markets would be open to all participants, but only on a cash-cleared basis and only via registered GHG trading organizations.

**Border Adjustments.** The APA provides for a border adjustment mechanism to be implemented in the event that a global climate change agreement is not reached. In order to avoid any trade disadvantage to U.S. companies, the bill would require importers from countries that have not regulated GHG emissions to purchase allowances at the U.S. border.

### **Impact on EPA and State Initiatives**

**EPA Regulation.** In the absence of Congressional action, the EPA has taken steps to regulate GHG emissions under its existing authority under the Clean Air Act (42 U.S.C. §§ 7401–7626 (1970)) (the “CAA”). As of this year, the EPA requires certain large emitters of GHGs to report their annual GHG emissions. It has also proposed rules to regulate large sources of GHG emissions by imposing permit requirements under the CAA. Recently, the EPA issued a final “tailoring rule” to reduce the scope of its proposed permitting requirements as administrative hurdles bar immediate implementation. The tailoring rule reduces the initial number of entities subject to permitting requirements under the CAA, beginning with the largest emitters and phasing in other entities over the next six years. The EPA has also finalized a rule limiting GHG emissions from new light-duty motor vehicles.

If passed, the APA would prohibit the EPA from regulating GHGs under many existing CAA standards. However, it does not prohibit the EPA from regulating GHGs under other aspects of the existing CAA. For example, the APA directs the EPA and the Department of Transportation to set GHG and fuel economy standards in cooperation with states.

**State Preemption.** The APA prohibits states from operating cap-and-trade programs independently or through regional efforts, such as the Regional Greenhouse Gas Initiative currently in effect in the northeastern U.S. To ease the transition to a federal system, businesses could exchange state-issued allowances for new federal allowances. States that have issued state allowances would also receive federal allowances as compensation for lost revenue. States would still retain the authority to impose stricter GHG regulations than those imposed through federal regulations.

### **Transportation**

**Carbon Cap.** Transportation fuels would not be included in the cap-and-trade scheme. Instead, transportation fuels and other refined oil products would be subject to a carbon pollution cap beginning in 2013, with allowances sold through auctions but not traded on a market.

**Vehicle Manufacturing Incentives.** The APA includes a number of provisions designed to encourage the manufacturing of low-emission vehicles. Under the APA, the Department of Transportation would provide grants to advanced technology vehicle manufacturers and component suppliers to refurbish or expand existing facilities and to support advancements in engineering, such as advancements in the viability of electric cars. Additionally, the APA would allow the entire cost of a natural gas vehicle manufacturing facility placed in service before 2015 to be expensed and treated as a deduction in the taxable year in which the facility is placed in service. Half of the cost of facilities placed in service between 2015 and 2020 could be similarly expensed.

**Efficiency and Infrastructure.** As additional incentives to improve transportation efficiency and infrastructure, the APA would direct several billion dollars a year to maintenance of the interstate highway system, research and development activities, competitive grants and pilot programs and state and local initiatives.

**Aviation.** U.S. refineries producing aviation fuel would be subject to the APA's carbon pollution cap. The European Union is also attempting to regulate GHG emissions from international flights arriving or departing within its borders. The discussion draft authorizes the U.S. Federal Aviation Administration and the EPA to distribute allowances to compensate for compliance costs associated with international travel. Specifically, the APA provides for allowances to be distributed to compensate for the purchase of fuel in the U.S. for foreign air transportation if GHG emissions from the use of such fuel are regulated under a foreign or international system.

### **Nuclear Energy**

If passed, the APA would be the first major U.S. legislation intended to encourage the growth of nuclear facilities in decades. In order to reduce barriers to constructing new nuclear facilities, the APA would expedite the process for issuing combined construction and operating licenses. The APA would also expand regulatory risk insurance (which provides standby support for certain delays), increase federal loan guarantees for innovative technologies and fund nuclear research. Tax incentives include a 10% investment tax credit for certain construction expenses, increased availability of cash grants in lieu of the investment tax credit, a reduction in the accelerated depreciation period for new facilities to five years and expanded availability of tax-exempt private activity bonds for public-private partnerships.

### **Oil and Gas**

**Offshore Drilling.** Notwithstanding the ongoing oil spill in the Gulf of Mexico, Senators Kerry and Lieberman kept provisions allowing for offshore oil and gas drilling. However, the APA now enables a state to veto offshore drilling within 75 miles of its coastline and in cases in which a spill could significantly impact the state. It also includes revenue-sharing mechanisms for coastal states and state and federal conservation programs.

**Hydraulic Fracturing.** Hydraulic fracturing is an oil and gas extraction technique that involves injecting millions of gallons of fluid composed of water, sand and chemicals into drilled wells at high pressure. The Energy Policy Act of 2005 exempted hydraulic fracturing from regulation under certain Safe Drinking Water Act programs, and companies are not currently required to disclose the chemical components they use. If enacted, the APA would require companies to disclose the chemicals used in their operations in order to inform the public and environmental regulatory authorities of potential concerns associated with such chemicals.

## Coal

**Performance Standards.** In addition to instituting a cap-and-trade system, the APA amends the CAA to introduce performance standards for new coal-fired power plants permitted after 2008. These standards set GHG emission reduction requirements but would allow the EPA Administrator to impose more stringent standards for new coal-fired generation facilities in the future.

**Efficiency Incentives.** The APA would provide investment tax credits and accelerated depreciation treatment for retrofits of existing coal-fueled power plants, if the retrofits resulted in a significant decrease in GHG emissions. The discussion draft also considers providing additional allowances to replace coal-powered electric generation and funding the construction of new electric generation that results in a significant decrease in GHG emissions. However, these provisions are designated as “subject to discussion” in the draft.

**Carbon Capture and Sequestration.** The proposed legislation also includes funds for carbon capture and sequestration (“CCS”), a process that captures carbon dioxide and prevents it from reaching the atmosphere. Funding would be available for research and the deployment of new CCS projects. Tax and other incentives would encourage implementation and maintenance of CCS projects.

## Consumer Protection

Several provisions in the APA are intended to alleviate the impact of the proposed legislation on consumers. Emission allowances are provided to retail ratepayers of electricity, natural gas, home heating oil and propane. Consumers disproportionately affected by the APA’s implementation would be eligible to receive rebates under an energy refund program established under the Social Security Act. Working families would be eligible for refundable tax credits. Finally, the APA creates a Universal Trust Fund which would distribute 75% of all the revenue generated from specified sales of allowances to consumers in the form of rebates beginning in 2026. The remaining 25% would be applied towards the federal deficit.

## Renewable Energy

The APA includes significant funding for states to implement efficiency and renewable energy initiatives. It also increases available federal loan guarantees for non-nuclear renewable projects by \$17.5 million. However, the APA does not provide the strong federal incentives to transition to renewable energy that are in ACES. Currently, 29 states and the District of Columbia have implemented mandatory renewable portfolio standards (“RPSs”) under which certain utilities would be required to purchase a set amount of electricity from renewable sources. The APA leaves these state RPSs in place, but unlike ACES, it does not add a federal renewable electricity standard (a “Federal RES”). A Federal RES may be added to the bill when it is considered in the Senate, or when reconciled with ACES.

**Transmission**

The APA does not focus heavily on modernizing the electricity grid, although it does allocate allowances to states for the integration of renewable energy resources and distributed generation, demand response, demand-side management and system analysis. Whereas ACES would mandate coordinated regional and national planning for siting transmission lines, the APA contains no such provisions.

**POTENTIAL IMPACTS ON BUSINESSES**

The EPA and the Energy Information Administration are currently analyzing the APA to assess the costs and savings associated with the proposed legislation, as well as its projected effect on businesses and the economy. In the meantime, a number of industry and environmental groups have spoken out in favor of the legislation.

If passed, the APA would encourage investment in new nuclear facilities, which has generally been out of favor in the U.S. since the 1979 Three Mile Island accident. By putting a price on GHG emissions, expanding loan guarantees and funding for state initiatives for renewable projects and providing funds to states to encourage the development of renewable sources of energy, the APA could make wind, solar and other types of renewable energy more affordable and competitive.

Carbon-intensive businesses operating in the U.S. could face increased costs under the APA. Companies subject to GHG emissions caps may have to purchase emissions allowances or install pollution control equipment in order to reduce their GHG emissions. Even companies not directly regulated by the APA could be significantly affected as regulated companies seek to pass on compliance costs to their customers.

Companies filing reports with the U.S. Securities and Exchange Commission (the “SEC”) will need to consider the APA’s effects on their businesses given the SEC’s February 2010 interpretive guidance concerning obligations to disclose material impacts resulting from climate change legislation.

**NEXT STEPS**

Senators Kerry and Lieberman are currently meeting with different stakeholder groups to finalize the APA. After the draft is finalized, it will be up to Senate Majority Leader Harry Reid (D-Nev.) to decide whether to formally introduce the APA to the Senate. Some have speculated that Senator Reid will bypass committees and introduce the APA directly to the Senate floor. Others predict that the APA will not be introduced to the Senate this year. It remains to be seen whether the APA will be introduced and receive the 60 votes required for passage in the Senate. If it does pass, it will need to be reconciled with ACES. President Obama is expected to sign any climate change bill that Congress passes.

Other proposed measures with much narrower goals have been introduced in both chambers of Congress. These bills advocate for updating renewable fuels standards for liquid biofuels or addressing “energy-only” issues such as renewable energy and energy efficiency. Congress may choose to pass a more limited energy bill that does not regulate GHG emissions, or to integrate other proposed legislation into the APA.

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We will continue to monitor developments related to the energy and climate change legislation. Please feel free to contact us with any questions.

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