Published on *The National Law Review* https://natlawreview.com

Carbon Markets Roundup 2018 Year in Review

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Last year saw significant efforts to either impose a price on carbon or reform existing programs, and in some cases roll those programs back. The Paris Agreement advanced a critical step, but without settling on rules for offsets and a new market mechanism, much remains in flux. Carbon pricing proposals proliferated, but not without political headwinds in some jurisdictions, including the rollback of Ontario's cap-and-trade program and riots in Paris over an increased gas tax. Will we look back on 2018 as a watershed year? It's hard to tell – but it certainly kept us busy.

United States

California Extends and Reforms Cap-and-Trade Program, Updates Low Carbon Fuel Standard

In 2017, California rebooted its cap-and-trade program by enacting Assembly Bill 398 (AB 398) to reauthorize and extend the program through 2030, signaling the program's essential role in achieving California's GHG reduction target for 2030 of at least 40 percent below 1990 levels set by Senate Bill 32 (SB 32). In December 2018, the California Air Resources Board (CARB) adopted implementing regulations, setting a new allowance price ceiling that will start at $65 in 2021 and increase each year by five percent plus the rate of inflation. At the most recent auction, all allowances sold for $15.31 each, 78 cents higher than the $14.53 auction floor price.

CARB also changed the rules for its offset program. Currently, an entity may to use offsets for up to eight percent of its compliance obligation, but the new rules reduce offset usage limits to four percent for 2021 to 2025, rising to six percent for 2026 to 2030. The rules further provide that no more than half the offsets used by an entity can be sourced from "projects that do not provide direct environmental benefits in the state." These changes are aimed at increasing environmental co-benefits in California from offset projects.

Consistent with SB 32, CARB also adopted updates to its Low Carbon Fuel Standard Regulation (LCFS), which became effective on January 4, 2019. With this set of amendments, CARB is targeting

to reduce the carbon intensity of fuels in California by 20 percent from a 2010 baseline by 2030. CARB also adopted amendments to its Regulation on Commercialization of Alternative Diesel Fuels based on a new environmental analysis mandated by court decision. These amendments include (1) requirements for third-party verification of fuel pathways and reporting, (2) incorporation of a stringent Carbon Capture and Sequestration protocol for credit-generation, and (3) provisions to allow crediting of zero-emission vehicle fueling infrastructure.

RGGI Set to Expand Membership to Virginia and New Jersey

In September 2018, the Virginia Department of Environmental Quality released a revised proposed regulation aimed at establishing a GHG trading program, creating a pathway towards full RGGI membership. The revised rule contains a reduced CO2 allowance budget, a change in line with earlier comments from RGGI and other RGGI member states. The proposal includes a base budget of 28 million tons, beginning in 2021, with a 3% annual reduction for annual budgets and allocations through 2030. Virginia made the change to help allay concerns that its proposed rule was not ambitious enough, and could potentially result in a surplus of allowances. Virginia's Air Pollution Control Board decided to move forward with the revised rule and the revised, re-proposed rule is open for public comment from February 4 through March 6, 2019.

New Jersey (which withdrew from RGGI in 2011) plans to rejoin RGGI and released its proposed regulations to do so in December 2018. Both Virginia and New Jersey are on track to begin participating in RGGI in 2020. While RGGI allowance prices rose last year, selling for $5.35 at the December auction (auction prices hadn't broken $5 since early 2016), they are still well below prices in California and the EU.

Northeast States Agree to Begin development of a Transportation Climate Initiative

On December 18, 2018, nine states and Washington, D.C., agreed to begin development of a regional cap and trade program covering transportation emissions. If implemented, the Transportation Climate Initiative (TCI) would establish a regional program to impose a declining cap in emissions from transportation sources. Details are thin at this stage, but with transportation becoming an increasingly large portion of northeast GHG emissions, TCI could ultimately result in a significant regulatory and carbon pricing regime. The current state lineup largely mirrors RGGI and consists of: Connecticut, Delaware, Maryland, Massachusetts, New Jersey, Pennsylvania, Rhode Island, Vermont, Virginia, and Washington, D.C.

Oregon Adopts Updates to the Clean Fuels Program; Challenger Seek Supreme Court Review

On November 15, 2018, the Oregon Environmental Quality Commission adopted amendments to the Oregon Clean Fuels Program. These amendments included updates to the models used to determine the carbon intensities of fuels and the resulting changes to the lookup table values, clean fuel standards, energy economy ratios, and temporary fuel pathway codes. The amendments also provide new categories of fuel applications that can be used to generate credits, including forklifts and transport refrigeration units, and added new fuels that could generate credits such as alternative jet fuel and renewable propane.

The program has not been without controversy. On September 9, 2018, the Ninth Circuit affirmed the

dismissal of a lawsuit challenging the Oregon Clean Fuels Program. *Am. Fuel & Petrochemical Manufacturers v. O'Keeffe*, 903 F.3d 903 (9th Cir. 2018). On January 9, 2019, the American Fuel & Petrochemical Manufacturers, American Trucking Associations, Inc., and Consumer Energy Alliance filed a petition for writ of certiorari seeking review of the Ninth Circuit's opinion upholding the Oregon Clean Fuel Program. In particular, they sought review on the questions of whether the Program's regulation of fuels based on a "life-cycle" analysis constituted impermissible extraterritorial regulation. Notably, a similar attack on California's LCFS has recently (and in the past) proven unsuccessful. *See Rocky Mountain Farmers Union v. Corey*, 913 F.3d 940 (9th Cir. 2019) ("However, our panel need not linger on whether the Constitution could support such a claim, because we are bound by recent circuit precedent that has settled whether a program very similar to the LCFS is inconsistent with the structure of the Constitution." *citing O'Keeffe*, 903 F.3d at 916-917).

Washington Voters Reject Carbon "Fee"

Last November, voters in Washington State rejected Ballot Initiative 1631, a potentially ground-breaking ballot initiative that would have established an economy-wide carbon fee. Had it passed, Washington would have become the first U.S. state to enact a carbon fee or tax, and also the first jurisdiction worldwide to place a price on carbon through a ballot initiative. Ballot Initiative 1631 would have imposed a $15 per-ton "fee" on CO2 emissions, increasing by $2 annually until 2035, when the fee would top out at $55 per ton. At that point, state lawmakers could either freeze the fee or vote to continue annual increases. Proponents have labeled the carbon price as a "fee" since fees, under Washington State law, can be targeted towards certain uses, while taxes can be spent on any government expenses.

Interestingly, carbon tax proposals are on the legislative agenda in numerous other states and in 2018 a bipartisan group from the U.S. Congress proposed "The Energy Innovation and Carbon Dividend Act," which would impose a tax of $15 per ton of carbon dioxide beginning in 2019, increasing by $10 each year. Prospects for this bill are dim in the short term, but may indicate a renewed interest in carbon pricing at the federal level.

Canada

Canada Imposes Carbon Tax on Four Provinces

Under the Greenhouse Gas Pollution Pricing Act, S.C. 2018, c. 12, s. 186, Canada will implement a revenue-neutral carbon tax starting in 2019. While several provinces already have their own carbon-pricing schemes, the federal program will serve as a backstop and impose a carbon price in provinces without an equivalent scheme. GHG emissions will be taxed at $20 per ton in 2019, rising at $10 per ton per year until reaching $50 per ton in 2022 (where it will remain unless the legislation is updated). Three provinces already have carbon pricing schemes, and four more are under development. Ontario is one of the provinces that will become subject to the new national tax, which it has vowed to fight in court, arguing that Ottawa's carbon pricing plan is unconstitutional. Earlier in 2018, Ontario ended its cap-and-trade program and withdrew from the Western Climate Initiative, which had linked it to California and Quebec.

International

EU ETS Has Banner Year

The EU Emissions Trading System (EU ETS) had a banner year in 2018, with allowance process

tripling. On February 27, 2018, the Council of the European Union approved revisions to the EU ETS. For several years, the EU ETS was plagued by an over-allocation of allowances. The reform package introduces three new elements: (1) an annual 2.2 percent reduction of the GHG emissions cap; (2) doubling of the number of allowances placed in the market stability reserve (MSR) until the end of 2023; and (3) limiting the validity of MSR allowances beginning in 2023. These changes are aimed at enabling the EU to reduce overall GHG emissions by at least 40 percent below 1990 levels by 2030 and meet corresponding commitments under the Paris Agreement. The practical effect was swift: EU ETS allowance prices started 2018 below €8 and ended the year just over €24.

Paris Agreement Advances but Still Lacks Rules for Market Mechanisms and Offsets

Paris Agreement parties are working towards development of a “Paris Rulebook” that would establish ground rules to facilitate achieving the “nationally determined contributions” that form the basis of the Paris Agreement. Progress on the Paris Rulebook has been slow but advanced significantly during the 24th Conference of Parties (COP 24) in Katowice, Poland. During COP 24, the Parties reached agreement on numerous aspects of the Paris Rulebook, including key carbon accounting methodology and reporting provisions. While these developments were a key step towards implementing the Paris Agreement, the parties could not reach agreement on the Article 6 market mechanisms.

The market mechanisms created by Article 6 of the Paris Agreement are fundamental and would establish a new carbon market and new offset provisions. The Kyoto protocol’s offset programs (the Clean Development Mechanism (CDM) and Joint Implementation mechanism) experienced a lack of transparency and significant market failures, resulting in a flood of offset credits that threatened to undermined the integrity of the Kyoto protocol. Parties to the Paris Agreement are trying to avoid these past mistakes while addressing concerns regarding the transition of CDM offset credits into a new market mechanism.

At COP 24, Brazil and a few other parties opposed provisions related to the treatment of Clean Development Mechanism offset credits, highlighting one of many differences between developed and developing countries in how the Paris Agreement should be implemented. That disagreement forced the parties to shelve discussion of market mechanisms until COP 25, which will be held in Chile in November 2019.

The Kigali Amendment Enters Into Force, Without the U.S.

The Kigali Amendment to the Montreal Protocol, which aims to phase down the use of hydrofluorocarbons (HFC), entered into force on January 1, 2019. During 2018, a number of countries ratified or approved the Kigali Amendment, bringing the total to 69 parties, including the EU, the United Kingdom, and many other European and African nations.

The U.S. was instrumental in developing the Kigali Amendment under the Obama Administration, but has yet to ratify it. On June 4, 2018, a number of Republican senators sent a letter to President Trump asking him to submit the Kigali Amendment to the Senate for ratification, and it appears the Senate is close to having the 67 votes it would need. The U.S. Chamber of Commerce has indicated that ratification of the Kigali Amendment would benefit U.S. industry and “boost output in the U.S. manufacturing sector by an additional $12.5 billion by 2027.” But despite bipartisan and broad industry support, the Trump Administration has not taken a position on whether to ratify the Kigali

Amendment. In fact, during 2018 the Trump Administration took multiple actions to roll back HFC regulations.

U.S. states have begun to fill the gap left by federal inaction on HFCs. In March 2018, CARB adopted rules replacing certain federal regulations. And on September 13, 2018, California's then-governor Jerry Brown signed the California Cooling Act (SB 1013), codifying into California law the Obama Administration targets for reducing HFCs after a federal court struck down related federal provisions earlier in 2018. The law also supplements CARB's authority to adopt rules limiting the use of HFCs, and creates an economic incentive program to accelerate the transition from HFCs to alternative substances. New York, Maryland, and Connecticut announced plans to take similar action.

Airlines Set to Begin Offsetting Emissions Increases

The Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) was agreed to in October 2016 by 191 countries in the International Civil Aviation Organization (ICAO), with the central goal of stabilizing aircraft emissions at 2020 levels by offsetting future GHG emissions increases. In 2018, ICAO finalized a set of standards and recommenced practices that became applicable January 1, 2019. ICAO, *First Edition of Annex 16 to the Convention on International Civil Aviation*, Vol. IV (First Ed. Oct. 2018). While CORSIA has largely flown under the radar, it is a significant program that will create a large market for carbon offsets starting in 2021.

China

China's Environmental Authority Seizes Leading Role on Climate Change Policy

China's Ministry of Ecology and Environment (MEE), the country's top environmental agency, officially assumed the primary role in China's climate change policymaking on September 11, 2018. This shift occurred following a number of measures from China's leadership in 2018 to shift power on climate issues from the country's macroeconomic planning authority to its environmental authority.

According to a new ministerial organizational plan released on September 11, MEE is now "responsible for the work on addressing climate change." Its powers include "organizing the design and drafting of major strategies, plans, and policies relating to addressing climate change and reducing greenhouse gas emissions; jointly leading the arrangement of, and the participation in, the international negotiations on climate change with relevant ministries; and responsible for China's implementation of the UNFCCC." The Ministry is authorized to establish a division dedicated to climate change issues.

Historically, China's domestic climate policymaking authority was heavily vested in the National Development and Reform Commission (NDRC), which primarily controls China's economic planning. As an example, China's State Council, the country's cabinet, operates a consultative group called the National Leading Group for Climate Change, Energy Conservation, and Emission Reduction (the Climate Change Leading Group). Since 2013, NDRC has been responsible for the routine work of this Group despite wide participation by various ministries.

In March 2018, China's national legislature approved a major reorganization of the State Council, which required that NDRC transfer its climate policy authority to the reshaped, power-enhanced MEE. On July 19, 2018, the State Council reformed the Climate Change Leading Group, noting that both MEE and NDRC are now responsible for the Group's routine work. The organizational plan for MEE is the latest signal that China's environmental authority is gaining increasing control over the

country’s climate policy decisions.

China Advances Plans for National Carbon Emission Trading in the Power Sector

China launched regional pilot trading platforms in 2013, aimed at multiple sectors. China had hoped to transition the regional pilots to a nationwide emissions trading scheme by 2017, but was unsuccessful. Some observers fear that the transition of power to the MEE has the potential to either disrupt this process (MEE has less political clout than the NDRC).

China’s MEE organized a conference on September 5, 2018, to plan for national carbon trading in the power sector. Power sector representatives, the civil aviation authority, officials from NDRC, local environmental regulators, and a number of trade groups and research institutes attended the conference. Following a policy plan released in December 2017 and subsequent work in early 2018, the power sector is likely among the first participants in China’s anticipated national carbon market. According to the trade press covering the conference, MEE is preparing a number of framework rules on regulating the national market, as well as on incorporating verified voluntary reduction credits into the trading scheme. MEE also plans to organize training activities for carbon trading professionals among local regulators, carbon emitting entities, and third-party certifiers.

China Solicits Second Round of Comments on Proposed Renewable Portfolio Standard

During 2018, China’s NDRC solicited comments on the Power Generation Allowances and Assessment Measures for Renewable Energy rule, a proposal for a renewable energy quota and allowance trading policy, according to a draft leaked in September 2018. This was the second round of comment solicitation, following a similar process in March 2018.

Under the leaked September Draft:

- The national government would assign a renewable energy percentage target to each province every year.
- Six categories of entities (“quota obligation entities”) must fulfill an annual renewable energy quota, calculated based on the total amount of sold or consumed electricity and the provincial renewable energy percentage target. Quota obligation entities would include the state or provincial power grid companies, power distribution and sale companies, independent electricity sellers, certain electricity users, and certain enterprises with their own power plants.
- “Green certificates” issued for renewable energy allowances would be traded on a market, and can be used to meet the quota requirement. Ordinarily green certificates are traded along with the electricity sales. NDRC expects to promulgate more detailed rules on green certificates.
- Failure to fulfill the quota requirement would result in a payable “compensation”. The collected compensation would be transferred into a national renewable energy subsidy fund. Other penalization measures, including restrictions on future projects, might attach to entities that refuse to comply.
- Provisions to address recent deficits in the subsidy fund.
- Sets a target of 35% renewable energy by 2030.

National Law Review, Volume IX, Number 46