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Offsets survive challenge as cap-and-trade moves forward

By Pat Dennis, Krista Hernandez
and Sheldon Evans

On March 25, the last hurdle was cleared when a California court entered final judgment in *Citizens Climate Lobby et al. v. California Air Resources Board*, No. CGC-12-519554, a case with national and international implications. In its decision, the court upheld the California Air Resources Board's (CARB) adoption of four offset protocols to help implement California's vanguard Global Warming Solutions Act of 2006 (AB 32). Health & Safety Code Sections 38500 *et seq.*

The overarching mandate of AB 32 is to reduce California's greenhouse gas emissions to 1990 levels by 2020. It was passed during a time when the economy was strong, but even then faced opposition from industry. Ultimately, a bipartisan compromise was reached in the Legislature allowing the program to move forward, but giving CARB the discretion to use market mechanisms (potentially including offsets) to help achieve the reductions.

After years of investigation, fact-finding, and public comment, CARB adopted the cap-and-trade program as one of the vehicles to achieve the required greenhouse gas reductions. The program calls for a decreasing annual cap on aggregate greenhouse gas emissions from certain, specified industries including any source with annual greenhouse gas emissions of greater than 25,000 tons. As part of the program, CARB adopted four offset protocols, in which unregulated entities can create greenhouse gas offset credits by taking on projects that have been verified to reduce greenhouse gas emissions, so long as such reductions are not otherwise required by law and are "additional." Thus, if a regulated greenhouse gas emitter cannot meet the decreasing cap requirements, it may purchase offset credits to cover up to 8 percent of its total emissions.

The four offset protocols were originally developed by the Climate Action Reserve, a nonprofit foundation created by state law in order to develop the greenhouse gas emission inventory development methods. After years of study, the reserve developed, and CARB adopted, the four offset protocols challenged

in the lawsuit: Livestock Projects; Ozone Depleting Substances Projects; Urban Forest Projects; and U.S. Forest Projects. Each of the protocols identifies a specific type of nonregulated greenhouse gas reduction activity and explains how the greenhouse gas reductions are achieved, why such reductions do not otherwise occur in a "business-as-usual scenario" — i.e., without the financial incentive of being valued as an "offset" — and how such activity can qualify for offset status.

The petitioners challenged each protocol, claiming that they do not comply with AB 32's mandate that offsets be "additional." One of the petitioners, the Citizens Climate Lobby, was led by two EPA lawyers who disagree with cap-and-trade programs that include offsets, preferring instead the use of a carbon tax. They had expressed their ideological opposition in a letter to Congress in 2010, which attempted to discourage the federal government from adopting its own cap-and-trade program using offsets which was contemplated in bills then pending before Congress.

The court's decision to preserve the four offset protocols in the program to assist in allowing industry to achieve AB 32's mandated reductions was a step in the right direction for both the environment and industry.

Specifically, the petitioners alleged that the protocols did not comply with AB 32's requirement that offsets be "additional," meaning that "the [offset] reduction is in addition to ... any other [greenhouse gas] reduction that otherwise would occur." In an apparent strategic effort to obtain the more rigorous *de novo*, or the closely related independent judgment, standard of review, the petitioners did not challenge CARB's definition of "additional," which made clear that greenhouse gas reductions would qualify as offsets so long as they "exceed any [greenhouse gas] reductions or removals that would otherwise occur in a conservative business-as-usual scenario." Thus, the petitioners' ultimate argument was straightforward — CARB's stan-

dardized approach for qualifying offset projects under the protocols could end up granting offset credits to nonadditional projects in violation of the statutorily used term "additional."

Responding to this challenge was a coalition of CARB, the named respondent, three interveners, plus one amicus. The coalition was remarkable for its political diversity, which was a testament to the support of the necessity of offsets to help achieve the reductions contemplated by the program. The interveners were the Climate Action Reserve, the Environmental Defense Fund, and a group of energy industry businesses whose greenhouse gas emissions would be regulated under the program. The Nature Conservancy participated as amicus.

The respondents argued that since the petitioners did not challenge CARB's regulatory definition of "additional," the only inquiry before the court was whether each of the challenged offsets met this regulatory (and unchallenged) definition. In making this argument, the respondents said that the performance standards-based approach used to develop the protocols was rational and more efficient than a case-by-case approach. Indeed, the Clean Development Mechanism, a case-by-case approach used to screen offsets and adopted through the Kyoto Protocol, has been widely criticized as inefficient and impractical before CARB adopted the program at issue.

After months of briefing and a full day of oral argument, the court was persuaded that (1) CARB had been given the discretion to adopt its regulatory definition of "additional," including the use of a performance standards-based approach, and (2) that each of the four challenged offsets complied with the regulatory definition. The court adopted a bifurcated standard of review to come to its conclusions on these questions.

First, the court used the *de novo* standard of review in holding that CARB's adoption of a regulatory definition using a standards-based approach in determining "additionality" was within the Legislature's intent. The court reviewed the statutory language, noting how difficult it is to determine additionality. This is true for either standards-based approaches or case-by-case assessments. As the respondents contended, there is no way

to read minds to determine whether a project operator would have undertaken an emission reduction project in the absence of the market mechanism of offsets as an incentive. Thus, the Legislature could not have intended to require a perfect mechanism for determining "additionality." This logic, along with the petitioners' concession at oral argument that a performance standards-based approach is within the bounds the Legislature set for CARB, appears to have convinced the court that CARB had the authority to define "additional" as it did.

Second, the court used the arbitrary and capricious standard to review each of the four challenged offsets, and whether they were "additional" as defined by CARB in its regulations. In making this determination, the court identified several filtering processes within each of the challenged offset protocols that disqualify almost all nonadditional projects. For example, the Urban Forest Project Protocol requires project operators to maintain trees generating offset credits for at least 100 years; if a tree dies or is cut down, the operator must replace it or forfeit their offset credits. These meticulous filters demonstrate the rigorous requirements of the offset protocols, and CARB's efforts to define "additional" in a standard way for each particular type of project so as to exclude projects that would otherwise occur in a "business-as-usual" scenario.

The court's decision to preserve the four offset protocols in the program to assist in allowing industry to achieve AB 32's mandated reductions was a step in the right direction for both the environment and industry. It is a case that the nation and the international community will continue to watch as we prepare for the reconsideration of a federal greenhouse gas legislative program.

Pat Dennis is a partner in the Los Angeles office Gibson, Dunn & Crutcher LLP.

Krista Hernandez and Sheldon Evans are associates, also in the Los Angeles office. They are members of the firm's Environmental Litigation and Mass Tort Practice Group. The authors represented the Climate Action Reserve in the lawsuit discussed in this article.