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## Readying For ACES And Climate Change

*Law360, New York (September 14, 2009)* -- It appears certain that there will be climate change legislation in the United States in the near future. As a result, we expect that both upstream and downstream sources of greenhouse gas emissions will face increased economic costs.

While the final content of such legislation remains unclear, we believe that companies that are significant sources of GHGs can benefit by anticipating such regulation now, developing plans to reduce emissions, banking unnecessary emissions at GHG-producing facilities if possible and creating verifiable, additional and permanent offset credits where feasible.

If reductions in GHG emissions are not readily achievable, then companies should plan carefully to mitigate their future increased costs of doing business in a carbon-restricted U.S. market.

If you are evaluating an acquisition of or investment in a business with GHG emissions or that is a significant energy consumer, you need to consider the implications of climate change legislation right now.

Given the current level of attention being paid to the proposed overhaul of the U.S. health care system, it is almost hard to recall that just two months ago, on June 26, 2009, the U.S. House of Representatives passed the historic American Clean Energy and Security Act of 2009 ("ACES Bill"), H.R. 2454, by a vote of 219 to 212.

The ACES Bill, also commonly referred to as the Waxman-Markey Bill, offers a comprehensive climate change and energy regulatory framework.

As widely reported, the ACES Bill addresses GHG emissions through a "cap-and-trade" program, includes a renewable energy portfolio standard and proposes broad oversight of the carbon trading markets that are expected to develop.

The ACES Bill currently is under consideration by the U.S. Senate. It likely will be combined with similar legislation proposed by several Senate committees before a final Senate bill takes shape and is subject to a vote.

A conference of House and Senate members then would convene to reconcile differences between the ACES Bill and the final Senate version.

According to published statements by Sen. Barbara Boxer, D-Calif., the Senate will take up climate change and energy legislation upon returning from recess this September. Sen. Harry Reid, D-Nev., has stated that he expects a vote on a final bill in the Senate in December.

Notwithstanding the current 60-vote Democratic majority in the Senate, passage of the ACES Bill or any comprehensive climate and energy legislation is not a sure thing.

Nevertheless, there appears to be tremendous momentum and pressure domestically and internationally for the United States to address climate change and GHG emissions this year or early in 2010.

Even without certainty as to the final scope and timing of climate and energy legislation, many affected companies and industries are considering how they may be impacted and have started planning new ways to do business that take into account expected curbs on GHG emissions in the United States and elsewhere.

While it may be premature to commit the more than 1200-page ACES Bill to memory, anyone evaluating potential acquisitions and investment opportunities in industries that produce or consume significant amounts of energy or use carbon-based materials should develop a basic understanding of key aspects of this proposed legislation so that they can take into account, at least in broad terms, the potential direct and indirect impacts and recognize related challenges and opportunities.

The ACES Bill, and likely any final U.S. climate change legislation, would seek to reduce global warming by creating incentives to reduce domestic GHG emissions, primarily through a cap and trade program.

A cap-and-trade program, in general terms, would impose an aggregate national emission ceiling, or cap, on GHG emissions and establish a property right, or emission credit, entitling owners to emit a specified amount of carbon (or other specified harmful pollutants) into the atmosphere.

The legislation will likely distribute some emission rights to highly affected or strategic companies or industries and require that other sources of GHG emissions acquire such rights.

The legislatively mandated cap would shrink over time, forcing sources either to reduce their emissions or to acquire additional emission credits.

The creation of GHG emission property rights and evolving demand for such rights would give rise to a market in such rights, generating the “trade” aspect of the program.

### **What's Covered By ACES**

GHGs consist of more than just carbon dioxide. ACES also proposes to regulate emissions of methane, nitrous oxide, hydrofluorocarbons and other carbon equivalents from chemical manufacturing processes at industrial stationary sources, perfluorocarbons, sulfur hexafluoride and nitrogen trifluoride (each measured in terms of tons of carbon dioxide equivalents).

### **Who's Covered By ACES**

For purposes of the ACES Bill, covered sources would include a combination of upstream sources (the point at which fuel enters commerce), such as producers and importers of petroleum and local distributors of natural gas; and downstream sources (the source of emissions), such as electric utilities; stationary sources in certain specified heavy industrial sectors, such as primary aluminum production and cement production, regardless of the level of GHG emissions; industrial, chemical or petrochemical facilities that emit more than 25,000 tons of GHGs, including food processing, pulp and paper manufacturing, lead and zinc production facilities; fossil fuel-fired boilers that emit more than 25,000 tons of GHGs; and geologic sequestration sites, among others.

### **How ACES Would Work**

The ACES Bill proposes caps on emissions from covered sources to reduce national carbon emissions by 3% below their 2005 levels by 2012, 17 percent by 2020, 42 percent by 2030 and 83 percent by 2050.

Such sizable national reductions in GHGs would be accomplished through a complex regulatory program focusing on covered sources and a cap and trade system requiring that covered sources hold one emission allowance for each ton of GHG that is emitted.

### **The Proposed Cap**

The proposed cap on emissions from individual covered sources would be based on GHG emissions in a specified baseline year. As of April 1, 2013, electric utilities, fuel producers and importers, and fluorinated gas manufacturers would be required to hold emission allowances capped at 2012 emission levels.

As of April 1, 2015, industrial, chemical and petrochemical sources that emit more than 25,000 tons of GHGs would be required to hold emission allowances capped at 2014 emission levels. As of April 1, 2017, local gas distribution companies would be required to hold emission allowances capped at 2016 emission levels.

## Meeting the Cap

Under the ACES Bill, emission allowances would be allocated to covered sources by the government, as well as sold at auction.

Over time, the amount of allowances freely distributed would decline, and the amount that covered sources would be required to purchase through auctions would increase. Excess allowances could be traded within the regulated source population.

The ACES Bill also would permit covered sources to bank or borrow excess emission allowances from other years. Covered sources could acquire “off-set” credits, which would be created through verifiable, additional, permanent GHG emission reductions, avoidance or sequestration.

Accordingly, a covered source could meet its cap by reducing emissions to the amount of its allocated allowances, borrowing from future or banked allowances, acquiring additional allowances at auction or acquiring offset credits (which would be discounted in order to be used).

Note, however, that the ACES Bill does not identify the volume of free allowances that individual sources could expect to receive, nor the ultimate availability and price of such allowances and off-sets in the market.

Assuming that Congress passes some form of climate change legislation that generally incorporates a cap and trade framework, there are some questions you’ll want to ask acquisition and investment targets in potentially affected U.S. industry sectors.

Consider asking the following of acquisition and investment targets:

- Do you emit GHGs? (Don't just focus on carbon, but take into account carbon equivalent emissions of other GHGs, some of which will create higher reduction or off-set costs.)

- If so, what volume of GHG emissions is discharged annually? Greater or less than 25,000 tons? (Review historic performance data, not just recession-era production data.)

- Do you anticipate increases in GHG emissions in any of the next five years? If so, by what amount? Are increases inevitable if you increase production?

- Have you evaluated ways to reduce GHG emissions? (Can you economically shift production to locations with lower GHG emissions? Are there technological or material changes that could limit future GHG emissions? At what cost?)

- Have or can you create, bank or buy emission reduction credits? (Consider timing of plant shutdowns/ reductions in production.)

- Have you evaluated how to cover potential shortfalls in emission allowances? Would you have access to state off-set credits under state-issued allowance programs, such as the California, National Regional Greenhouse Gas Initiative or the Western Climate Initiative?
- Even if you are not a significant emitter, are you a significant transportation fuel or electricity consumer? (If the final legislation regulates upstream sources, downstream consumers can expect to experience significant price increases.)
- Have you had an energy audit to identify potential savings in energy consumption on the facility level or throughout the supply chain?
- Have you considered distributed generation of renewable energy, such as solar or wind?
- Have you evaluated using stimulus dollars to fund technological changes or renewable energy projects to reduce energy dependence?
- Are you a significant purchaser of carbon-intensive products from a developing country not now subject to carbon caps? If so, are you able to change production by switching suppliers or otherwise if a border adjustment measure, such as a carbon offset tax, makes the relationship economically infeasible?

The significance of the answers to these questions and what other questions you should be asking will necessarily depend on the scope and terms of a final climate change bill and the specific business of the target.

However, it is clear that most industry sectors should be thinking about their GHG and energy profile and planning for the direct and indirect costs of their GHG emissions and energy dependence. Prudent investors, at a minimum, should be prepared to start the dialogue.

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