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Court's Invalidation of Clean Air Interstate Rule Throws U.S. Emissions Trading Markets into Uncertainty

A recent ruling by the U.S. Court of Appeals for the D.C. Circuit invalidating the U.S. Environmental Protection Agency's Clean Air Interstate Rule (CAIR) has created turmoil in the U.S. emissions trading markets. The court's July 11 ruling in *North Carolina v. EPA* (No. 05-1244) vacated CAIR and its federal implementation program in its entirety, regardless of the "threat of disruptive consequences" that could result.

EPA promulgated CAIR in 2005 as a means of requiring "upwind" states in the eastern U.S. to control emissions that it predicted "contribute significantly" to exceedances of air quality standards in "downwind" states. The rule applied to sulfur dioxide (SO₂) and nitrogen oxides (NO_x) emissions, which contribute to the formation of fine particulate matter and ground-level ozone. In CAIR, EPA established SO₂ and NO_x "budgets" for 28 states and the District of Columbia; a two-phase compliance scheme required the SO₂ budgets to be met by 2010 and 2015, and the NO_x budgets to be met by 2009 and 2015.

The CAIR budgets for SO₂ and NO_x emissions were to be implemented through a regional cap-and-trade system. The SO₂ portion of CAIR was tied to EPA's Title IV Acid Rain Program; the NO_x program

established a new annual NO_x budget and expanded EPA's previous seasonal NO_x trading program. EPA provided annual and seasonal NO_x emission allowances to each state, and the states allocated the allowances to sources within the state. EPA found a cap-and-trade system to provide the most cost-effective method of reducing emissions within the region. Cap-and-trade programs result in faster emission reductions at lower cost because there is a financial incentive to reduce early and because sources can choose the most cost efficient method to comply (i.e., install pollution control equipment or purchase excess allowances from other sources).

Although the court did not find unlawful all provisions of CAIR, it ruled against EPA on several of the most fundamental parts of the regulation. These include CAIR's use of unrestricted interstate trading, the 2015 compliance deadline for Phase 2 of CAIR, the use of the Acid Rain Program as the basis for the SO₂ budget and trading program (i.e., requiring a greater than one-to-one surrender of Title IV SO₂ allowances), and EPA's allocation of NO_x allowances to states based on the proportion of coal-fired generation in the state.

Because EPA had consistently characterized CAIR as "one, integral action,"

the court vacated the entire rule. On remand, the court said that “EPA must redo its analysis from the ground up.”

Impacts on Trading Markets

Immediately after issuance of the decision, SO₂ and annual NO_x allowance prices dropped dramatically. (Seasonal NO_x prices remained stable because the court’s decision did not affect the previously established seasonal NO_x program.) Based on this precipitous

drop in allowance prices, one utility notified the SEC that it would take a third-quarter impairment charge on about \$100 million worth of SO₂ and NO_x allowances.

Uncertainty remains in the SO₂ and annual NO_x markets. Technically, CAIR remains in place until the court issues its mandate, which could be late in 2008 or even in 2009 if further appeals are pursued. As a practical matter, the court has declared the fundamental legal underpinnings of CAIR unlawful, making

it difficult for EPA to revive a program that involves unfettered interstate trading.

While EPA decides on its next steps, both in terms of the courts and the scope of its regulatory authority to revise the CAIR program, uncertainty will remain. Ultimately, congressional action to provide a firm legal basis for broad interstate trading of emission credits under the Clean Air Act may be needed to resolve this uncertainty.

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