

# CARBON OFFSETS: OPPORTUNITIES AND CHALLENGES FOR STATE CARBON TRADING SCHEMES

## Panel 4: Anticipation of Federal Programs

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### Introduction

This discussion paper examines the legal doctrine of preemption, and discusses the policy issues raised by integrating preexisting state/regional carbon markets into a national cap-and-trade system.

A recent Congressional white paper on the design of climate change legislation recognized that a “comprehensive national approach to climate change will be most effective when all levels of government – Federal, State, Tribal, and local – play active roles.”<sup>1</sup> The implementation of these roles requires a legal analysis of the question of preemption: whether and to what degree state law survives if a federal law appears to address the same regulatory matters.

This question often arises after legislation has passed, when conflicts arise over the scope of one or another level of government’s authority.<sup>2</sup> Yet legislative drafters who are cognizant of preemption issues may be able to delineate the respective roles of the various levels of government with significant clarity, easing the implementation of climate change legislation and avoiding (or at least limiting) costly court battles over the scope of state versus federal law.

### Preemption Doctrine

The Supremacy Clause of the United States Constitution states that federal law “shall be the supreme law of the land.”<sup>3</sup> Thus, while there is a judicial presumption against federal preemption,<sup>4</sup> where a clear conflict arises, the federal law will supersede state law. There are many ways in which state and federal law might interact or conflict, and preemption doctrine has evolved into a complex set of legal tests.<sup>5</sup> For simplicity, we have distilled preemption doctrine to three key questions: 1. Did Congress expressly preempt state authority or is the preemption implied? 2. Does federal law entirely displace state authority in the regulated area, or only in the case of a conflict? 3. Does federal law establish floor preemption, ceiling preemption, or both?

The first inquiry is whether Congress specifically stated that federal law would supersede state law in a given area (**express preemption**)<sup>6</sup> or whether it must be inferred (**implied preemption**).<sup>7</sup> Congressional intent is thus at the root of preemption analysis. If Congress is clear from the outset about what it wants to (and does not want to) preempt, and is reasonably good at predicting the areas of potential overlap implicated by a given law, then the task for a reviewing court will be easier. Although disagreements may still arise over the meaning of particular statutory terms, Congress can narrow the scope of disagreement by being more, rather than less, clear. Of course, there are instances when Congress is either unable or unwilling to be clear about its intent to preempt. In those cases, reviewing courts will construe congressional

intent using traditional tools of statutory interpretation, focusing on text, purpose, legislative history and the like.

The second inquiry focuses on the manner in which preemption occurs: does federal law entirely displace state authority to regulate in a given area (**field preemption**) or does federal law merely trump state law when there is a noticeable conflict (**conflict preemption**)? This question is important because it determines the scope of state power that remains after federal power has been exercised. Courts will apply field preemption in three circumstances: first, if federal regulation is so pervasive that there is no room for states to regulate; second, if the federal law touches on an area of unique federal interest that must preclude state laws on the same subject; or third, if the goals of the legislation reveal a need to preclude state action.<sup>8</sup> States have no room to maneuver in the case of field preemption as their very authority to pass legislation on a given subject has been removed. Conflict preemption analysis, on the other hand, focuses on how the federal and state laws interact. If it is impossible to comply with both the federal and state laws, then federal law will preempt state law.<sup>9</sup> The other scenario in which conflict preemption will govern is if a state law frustrates the purposes or objectives of the federal law.<sup>10</sup> For example, a federal law may be passed to ensure a uniform scheme of regulation for businesses that operate in multiple states. Varying state laws could disrupt such a scheme, threatening the goal of uniformity, and would thus be preempted.

The third question is: does the federal law set a minimum standard below which states may not go, but above which they may enact stricter legislation (**floor preemption**) or does the federal standard establish a level above which states may not regulate (**ceiling preemption**)?<sup>11</sup> This question illuminates some of the policy purposes behind federal action to preempt state law.<sup>12</sup> If it is more important to federal policymakers that states meet some minimum floor for a given policy question, then they may want to preempt state law only to the extent that it is less stringent than federal law. Note that in this case just because one law is more stringent than the other does not mean that it is impossible to comply with both in a conflict preemption analysis – regulated entities will simply have to comply with the stricter of the two. If policymakers believe that states may enact standards that are excessive, then setting a ceiling may be more appropriate. Setting both a ceiling and a floor is also a possibility; in effect this provides states a range in which to regulate. To the extent that federal policymakers value uniformity above other concerns or are dealing with states that show wide variation that needs to be contained on both ends, then some form of more rigorous preemption would be appropriate.

### **Offsets and Integration with Federal Climate Change Legislation**

Several bills proposing a national cap-and-trade program for greenhouse gases have now been introduced in Congress, raising the question of how Congress will ultimately address existing state and regional climate programs.<sup>13</sup> How to deal with offsets is just one component of this larger challenge. Generally, Congress has four options for how to approach existing state and regional greenhouse gas programs (and the offsets contained therein):

1. Allowing federal and regional/state markets to coexist;
2. Preempting regional/state markets with no effort at integration;

3. Allocating additional federal allowances to states with carbon markets and permitting those states to manage this integration; or
4. Accepting banked regional/state allowances in the federal trading system.<sup>14</sup>

Most of the proposed bills do not address carbon offsets with sufficient clarity or detail, but to the extent that federal legislation will encompass offsets, policymakers will have to confront a number of unique design challenges. First, there is the question (raised in Background Paper 1) of what counts as an offset. Central to this issue is the concept of additionality, or the idea that an offset project would lead to emissions reductions that are beyond those that would occur in the absence of participation in the carbon market.<sup>15</sup> There are a variety of plausible additionality tests and no consensus has yet developed regarding the appropriate definition.<sup>16</sup>

State and regional carbon markets may adopt different criteria for establishing additionality, and federal policymakers must decide what additionality criteria to use.<sup>17</sup> Depending on whether Congress's preferred additionality criteria are equivalent to, or more or less stringent than, state and regional criteria, federal policymakers must decide whether it is wiser to preempt non-federal law to create uniformity; set a minimum standard of additionality above which states may go (in order to preserve the environmental integrity of projects); set a ceiling above which states may not go (in order to ensure a steady supply of offset projects); or simply have state/regional and federal criteria exist alongside each other in some kind of integrated market. Because offset projects have different additionality profiles, the selection of a test will affect the supply of eligible offset projects. Thus, federal policymakers should keep in mind the type of carbon market they wish to create.

Second, once offsets have been defined at the federal level, or if multiple definitions have been maintained, there arises the question of the extent to which offsets can be used as part of a greenhouse gas reduction program. State and regional programs usually require that no more than a certain amount of emissions reductions be achieved through the use of offsets. Polluting entities tend to favor unlimited use of offsets to achieve emissions targets as this will likely reduce the price of compliance. However, environmental groups favor limiting offsets to force at least some emissions reductions at emitting facilities. Some commentators argue that limiting offsets is necessary to force large emitters to develop new carbon reduction technologies; others argue that more expansive use of offsets best achieves that goal. In any event, the ultimate federal guidelines may differ from state approaches, and if they do, policymakers will need to consider whether state and regional requirements should be allowed to deviate from federal standards and whether these deviations should only be allowed if they are more or less stringent than the federal standard.

Third, there is the question of what do with offset credits that have already been banked in state and regional systems.<sup>18</sup> Federal policymakers could exclude all banked offset credits from the federal market. This preserves the possibility that such banked credits could be used in state or regional markets that operate alongside or in some integrated fashion with the federal system. Alternatively, banked offset credits could be accepted wholesale into the federal market. This creates the danger that the market would be flooded with offset projects. If Congress were to choose this option, it could impose certain additionality criteria to limit supply as well as to put the onus on those who possess the banked credits to verify their quality. If a federal market were

integrated with a state/regional system through the use of allowances, the states could decide within that framework how to value banked offset credits in their own systems.

There is a further issue of timing when considering banked offset credits. Federal policymakers will want to have some control over the flow of offset credits into the eventual cap-and-trade market in order to maintain its stability and control credit price. Thus, they could reject the use of banked state/regional offset credits with an eye to allowing them later, subject credits to more or less stringent additionality criteria in order to control supply, or discount the credits to limit their impact in a federal market. All of these options present opportunities to reward or at least not penalize early actors in the offset market and encourage continuing investment in offset technologies at the state and local levels.

## References

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- <sup>1</sup> COMMITTEE ON ENERGY AND COMMERCE, CLIMATE CHANGE LEGISLATION DESIGN WHITE PAPER, APPROPRIATE ROLES FOR DIFFERENT LEVELS OF GOVERNMENT (February 2008), at 1.
- <sup>2</sup> California's effort to establish tailpipe emissions standards for greenhouse gases under the Clean Air Act, in the absence of federal standards prompted, among other things, a preemption challenge. *See Green Mt. Chrysler Plymouth Dodge Jeep v. Crombie*, 508 F. Supp. 2d 295 (D. Vt. 2007); *Cent. Valley Chrysler-Jeep v. Witherspoon* (E.D. Cal. 2006).
- <sup>3</sup> U.S. CONST. Art. VI, cl. 2.
- <sup>4</sup> *See* S. Candice Hoke, *Preemption Pathologies and Civic Republican Values*, 71 B.U. L. REV. 685, 732 ("Formal preemption analysis proceeds from a series of legal presumptions designed to preserve state regulatory power absent reliable proof that Congress intended to revoke the states' concurrent legislative jurisdiction.").
- <sup>5</sup> Preemption jurisprudence is notoriously convoluted and has come under severe criticism by legal scholars. *See, e.g.*, Erwin Chemerinsky, *Empowering the States when It Matters*, 69 BROOK L. REV. 1313 (2004); Caleb Nelson, *Preemption*, 86 VA. L. REV. 225 (2000); Stephen A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 767 (1994). Note that the vast majority of preemption cases involve potential conflicts between state and federal law in the domestic context. This paper does not cover the jurisprudence on foreign policy preemption in which state law conflicts with the foreign affairs power of the federal government. *See Am. Ins. Ass'n v. Garamendi*, 539 U.S. 396 (2003); *Zschernig v. Miller*, 389 U.S. 429 (1968).
- <sup>6</sup> *See Hillsborough County v. Automated Med. Labs, Inc.*, 471 U.S. 707, 713 ("First, when acting within constitutional limits, Congress is empowered to pre-empt state law by so stating in express terms.").
- <sup>7</sup> *See id.* ("In the absence of express pre-emptive language, Congress' intent to pre-empt all state law in a particular area may be inferred where the scheme of federal regulation is sufficiently comprehensive to make reasonable the inference that Congress "left no room" for supplementary state regulation.").
- <sup>8</sup> *See Wisconsin Pub. Intervenor v. Mortier*, 501 U.S. 597, 605 (1991).
- <sup>9</sup> *See English v. Gen. Elec. Co.*, 496 U.S. 72, 79 (1990).
- <sup>10</sup> *See Geier v. Am. Honda Motor Co.*, 529 U.S. 861 (2000).
- <sup>11</sup> *See* William W. Buzbee, *Asymmetrical Regulation: Risk, Preemption, and the Floor/Ceiling Distinction*, 82 N.Y.U. L. REV. 1547 (2007).
- <sup>12</sup> For a collective action perspective on these questions, see Robert I. Glicksman & Robert E. Levy, *A Collective Action Perspective on Ceiling Preemption by Federal Environmental Regulation: The Case of Global Climate Change*, 102 NW. U. L. REV. (forthcoming 2008).
- <sup>13</sup> The following bills have been proposed in the Senate. S. 2191, 110th Congress (as reported by S. Comm. On the Environment and Public Works, Dec. 5, 2007) (Lieberman-Warner); S. 1766, 110th Congress (Bingaman-Specter); S. 485, 110th Congress (Kerry-Snowe); S. 309, 110th Congress (Sanders-Boxer); S. 317, 110th Congress (Feinstein-Carper); S. 1177, 110th Congress (Carper); S.1168, 110th Congress (Alexander); S. 280, 110th Congress (Lieberman-McCain). The following bills have been proposed in the House. H.R. 1961, 110th Congress (Markey); H.R. 4226, 110th Congress (Gilchrest); H.R. 620, 110th Congress (Olver); H.R. 1590, 110th Congress (Waxman); H.R. 2069, 110th Congress (Stark).
- <sup>14</sup> Jonas Monast, *Integrating State, Regional, and Federal Carbon Markets: Options and Tradeoffs*, DUKE ENVTL. L. & POL'Y REV. (forthcoming 2008).
- <sup>15</sup> According to one definition, offset projects are additional if "the availability of offset credits is a decisive reason (although not necessarily the *only* reason) for pursuing the emissions reduction project." *See* Mark C. Trexler, Derik J. Broekhoff & Laura H. Kosloff, *A Statistically-Driven Approach to Offset-Based GHG Additionality Determinations: What Can We Learn?*, SUSTAINABLE DEV. L. & POL'Y, Winter 2006, at 31.

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<sup>16</sup>See Background Paper 1 for a discussion of additionality. For an excellent summary of different types of additionality tests, *see id.* at tbls. 1-2). The tables detail eight families of tests, their ease of development, application, and “true positive” and “true negative” rates. Tests detailed include: 1) Legal, Regulatory or Institutional Test; 2) Technology Test; 3) Investment Test; 4) Barriers Test; 5) Common Practice Test; 6) Timing Test; 7) Performance Benchmark Test; and 8) Project In, Project Out Test.

<sup>17</sup> There is the additional question of whether and how the state or federal government or 3<sup>rd</sup> party verifiers will be certifying projects (or the verifiers themselves) and monitoring projects after they begin.

<sup>18</sup> *See* Monast, *supra* note 15 for more extensive discussion of these various options.