Calif. Cap-and-Trade Linkage Suit Intricate, May Spark Global Doubt: Experts

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A recent Trump administration lawsuit challenges the legality of California's Cap-and-Trade Program's link with partner Quebec's, but the outcome could also have a far-reaching global influence on nations considering similar environmental policy, industry experts said.

The federal lawsuit against California could present an extremely unfavorable precedent for future linkages between foreign jurisdictions, said Nico van Aelstyn, partner at Sheppard Mullin LLP. Van Aelstyn has acted on prior litigation involving challenges to California's Cap-and-Trade Program.

"The potential chilling effect of a decision in this regard, or simply the filing of the lawsuit, is a less immediate, and less clear danger, but one that I think in some ways ... could have a longer term, greater impact," van Aelstyn said. "It really goes after the ability of subnational jurisdictions to link with each other, and that imperils what is seen more broadly as the path forward, globally, for addressing climate change."

The California and Quebec cap-and-trade programs have been linked since the start of 2014 and participate in four joint carbon allowance auctions per year.

On Oct. 23, the United Sates filed a civil complaint against California, the California Air Resources Board (CARB), several of the state's officers and the Western Climate Initiative (WCI) "for unlawfully entering a cap and trade agreement with the Canadian Province of Quebec," according to a federal press release, announcing the filing.

"The Constitution prohibits states from making treaties or compacts with foreign powers, yet California entered into a complex, integrated cap-and-trade program with the Canadian province of Quebec in 2013 without congressional approval," the release said.

Filing Causes CCA Secondary Market Uncertainty

News of the lawsuit immediately injected uncertainty into the California Carbon Allowance (CCA) secondary market unseen since 2017, before the state Legislature passed a measure to authorize the program through 2030.

Prior to the reauthorization, uncertainty about the fate of the program abounded, and was seen in price volatility that would rise and fall with the passage or failure of legislative measures impacting the program and rulings in the multiple legal challenges the program faced.

The certainty of the program's continuance brought by the reauthorization is what appeared to draw in significant speculative interest earlier this year, helping boost secondary market liquidity and allowance prices by over $1/mt in just a few months.

Unlike compliance entities, speculator involvement in the program is voluntary. If speculators were drawn to invest in the market given the relatively stable outlook of the program itself, that confidence may have been shaken by the Department of Justice's lawsuit.

On Oct. 23, the secondary allowance market sprang to life, with prices falling precipitously and trade liquidity exploding. Prompt, current year V19 October 2019 allowances traded that day from $17.04/mt to as low as $16.75/mt, according to OPIS pricing data.

That drop appeared to be a knee-jerk reaction and the price has more than recovered, to $17.15/mt on Nov. 20, according to OPIS.

Should the United States prevail in its lawsuit, delinking the California and Quebec markets would likely make them less liquid, van Aelstyn explained in an OPIS interview. The potential uncoupling could also represent less certainty in allowance supply and prices moving forward, he said.

But van Aelstyn noted that the lawsuit poses less of a fundamental threat to the program's existence than prior challenges against California. While unsuccessful previous attempts would have "effectively killed the whole program," the current federal lawsuit challenges only the linkage with Quebec.
California and Quebec would be allowed to continue to operate separately, even if the linkage is found to be unconstitutional, he said.

Breaking Down Legal Basis

Danny Cullenward, lecturer at Stanford Law School and policy director at Near Zero, a climate change mitigation research and analytics firm, told OPIS that the potential for the suit to succeed shouldn't be taken lightly.

"My take is that unlike a lot of the lawsuits and rollbacks pursued by the Trump Administration -- many of which are legally weak or even baseless -- this case presents a colorable legal question that shouldn't be ignored, even if market participants and governments think they have good arguments against it," Cullenward told OPIS. "There's enough in the compliant for a sympathetic judge to grant the requested relief. Whether that's going to happen is anyone's guess, but to pretend it's extremely unlikely is too dismissive."

The federal lawsuit contains multiple arguments against the joint participation, citing various parts of the U.S. Constitution. One question posed is whether California law conflicts with U.S. foreign affairs.

Although California's program may seem to conflict with what might be the personal views of President Trump, when considering the actual, concrete actions on foreign climate change agreements the U.S. has taken, the disparity is less clear, van Aelstyn said, pointing out that while "the U.S. has indicated it is in the process of withdrawing from the Paris Agreement, it has not withdrawn from the UNFCCC."

The United Nations Framework Convention on Climate Change is an international environmental treaty with 165 signatories that went into force in 1994. The stated objective of the treaty is to "stabilize greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system."

In addition, "the United States has not withdrawn from ICAO (International Civil Aviation Organization), and in fact, the U.S. recently voted in favor of ICAO's CORSIA [carbon] offsets program, so with regard to the U.S. foreign affairs position on climate change, the U.S. is still engaged in things that are consistent with California's position here," van Aelstyn said.

There is also no federal cap-and-trade program that conflicts with California's program, he said.

For these reasons, van Aelstyn considers that the state law vs. federal foreign affairs point of contention in the lawsuit fairly weak.

Treaty Characterization in Question

The suit also claims that the agreement with Quebec is a treaty, making it illegal under the U.S. Constitution, which prohibits subnational jurisdictions from entering into treaties with foreign powers.

"It's an agreement," van Aelstyn said of the California-Quebec linkage under the WCI. "The drafters of that agreement were very well aware of that [constitutional] provision and sought to avoid it being determined to be a treaty."

One clear indication that it is not a treaty, van Aelstyn said, is the fact that there are no binding or enforceable provisions, illustrated by Ontario's abrupt and rapid withdraw from the program last year, in which it ignored the delinkage notification guidelines of the agreement.

"There was nothing California could do about it. That underlines that it's not a treaty," Van Aelstyn said.

A separate argument in the suit references a provision in Article One of the Constitution prohibiting states from entering into "a compact" with a foreign power without congressional approval.

There is no dispute that California did not get congressional approval before linking its cap-and-trade program, but van Aelstyn does not believe that automatically invalidates the linkage.

While the cap-and-trade program may appear to be in violation, "the practice that has arisen as our society has grown larger and more complicated is that that kind of express approval is no longer necessary, because it's not efficient," he said.

"The fact is, states around the U.S. have been entering into agreement with foreign provinces -- mainly in Canada, some also in Mexico -- to regulate more local concerns," he said. He cited many agreements between Canadian provinces and northern U.S. Midwest states involving environmental and other management issues on the Great Lakes, which do not have explicit congressional approval.

Other agreements between U.S. states and "foreign" powers, including handling emergencies at the borders are in place as well, without congressional approval. Lacking explicit approval, these agreements have "de facto, implicit approval by congress, in the fact that it is silent with regard to those," he said.

In the case of California's cap-and-trade agreement, "you've got an agreement that is more than 6 years old, and Congress has never said 'boo,' "he said.

U.S. Administration Change May Drop Case

Meanwhile, the results of next year's U.S. presidential election could affect the status of the lawsuit.

Multiple sources told OPIS that while an initial decision is likely in the second half of 2020, the decision could be appealed, drawing the case out. If a new president assumes office in January 2021, and the case is still alive, he or she could order the Department of Justice to drop the federal challenge to California's program.

For example, in 2008, the Bush administration refused to grant California's waiver to set its own emission standards. California challenged the denial, and that challenge was pending before the Supreme Court when President Obama took office.

Obama promptly withdrew the U.S.'s opposition, and "effectively the case was killed," van Aelstyn said.

Ultimately though, a lot depends on the judge hearing the case as well, Van Aelstyn warned.

"This [case] kind of goes at the fundamental issue in constitutional jurisprudence. Your Justice Scalias of the world, with their originalist interpretation of the Constitution would say, "Well, that's what the words say, that's what they say.' End of story," he said.

"If you got a judge that was more of an originalist in the case of the Constitution, then this case has legs."

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