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EXECUTIVE BRIEF

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# Are Emission Reductions Property?

Analysis by John Palmisano, Managing Director

Commercially and legally enforceable rights are the foundation of emissions credit and emissions quota (allowance) trading systems. Without well-defined legal rights there can be no reliance on the trading system. However, what is becoming increasingly clear is that without well-defined property rights also attending these commercial and legal rights, notions of treating credits like commodities and tangible assets need to be reexamined by all the many stakeholders with interests in emissions trading, including the public at large. This Evolution Markets Executive Brief looks at a variety of "takings" issues surrounding $SO_2$ and $NO_x$ allowance, ERC/offset and greenhouse gas markets.

## What Are "Takings?"

When a governmental entity seizes a portion of private property or when the government imposes excessive restraint on the use of private property, it is termed a "taking." By private property we include land, buildings, water rights, crops, timber, minerals, oil, gas and many other resources. Takings have been deemed to occur when the government permanently or temporarily seizes or prevents the use of property. Taking into account this definition, it does not strain the mind to imagine that "takings" could be extended to emission credits or allowances.



Under the Fifth Amendment in the Bill of Rights in the United States Constitution, an individual is guaranteed that the government may not take his land without paying adequate compensation for it. This law is rooted in the 18th and 19th century legal traditions in England. Here the king was prohibited from acquiring a subject's property without paying adequate compensation for it. The concept was well established and generally honored by colonial governments. It continued to be honored without much controversy until the beginning of the rise of land use controls in the early 1900s.

During the 1920s, the U.S. Supreme Court wrestled with the concept of 'takings' in the context of local government zoning regulations restricting the use of real property. Beyond a certain limit, an action could be termed as taking. In 1922, the U. S. Supreme Court ruled (Pennsylvania Coal Co. v. Mahon) that a governmental regulation can cause a taking even without actual physical encroachment onto the property *i.e.*, when the government action "...goes too far." (See, Aspects of Regulatory Takings, A Legal, Economic, Political, and Social Analysis, Kristen Dunne, James Long and Sumit Singh at http://sac.uky.edu/~jdlong00/takings.html) However, by 1926, in Village of Euclid v. Ambler Realty, the Court found that a comprehensive zoning scheme restricting the placement of industrial, commercial and residential uses was not a taking as it did not go too far. The Court found that the community and most landowners benefited with a mutually enforceable and orderly system of land use restrictions.

The Fifth Amendment's takings clause reads: "nor shall private property be taken for public use without just compensation." As presently interpreted by the Court, that clause enables owners to receive compensation when: (1) their entire estate is taken by a government agency and title transfers to the government; (2) when their property is physically invaded by government order, either permanently or temporarily; (3) when regulation for other than health or safety reasons takes all or nearly all of the value of the property; and (4) when government attaches unreasonable or disproportionate permit conditions on use. Recent Supreme Court pronouncements (Lucas v. So. Carolina Coastal Council, 1992) continued a minor expansion of the Pennsylvania Coal Co. case adding factors such as expectations of economic return into the takings and "gone too far" consideration to be weighed against the exercise of acceptable police power over use of private property.

Hence, while the above list of protections might seem extensive, a moment's reflection should indicate the problem--and it is a very large one. Most regulations do not reduce the value of a person's property to zero or near zero. Rather, they reduce the value by 5 percent, 25 percent, 50 percent, or some other fraction of the whole. In those circumstances -- the vast majority of circumstances -- the owner might get no compensation. Only if completely wiped out by a regulation does one get compensation and, of course, only if the interest is deemed to be a property interest. (See, Protecting Private Property Rights from Regulatory Takings, Testimony of Roger Pilon, Senior Fellow and Director, Center for Constitutional Studies Cato Institute, Before the Subcommittee on Constitution Committee on Judiciary, United States House of Representatives, February 10, 1995).

What does this mean for emission traders? Let us consider three cases where legal entities believe they have an asset and consider several recent initiatives that might diminish the value of what these persons believe they have.

## New York's Regulatory Action Limits the Usefulness of $SO_2$ Allowances

The New York State Legislature (L. 2000, c. 36) enacted a law assessing fees upon certain allowance trades. The law was signed by Governor George E. Pataki and became effective on May 24, 2000. The New York Law applies to any sulfur dioxide ("$SO_2$") emission allowance originally issued, pursuant to Title IV of the federal Clean Air Act, to a generating source located in the State of New York (a "Select Allowance"). The New York Law imposes a penalty on any New York State source that sells or trades a Select Allowance that is eventually used by a generating source located in any of 14 other States (New Jersey, Pennsylvania, Maryland, Delaware, Virginia, North Carolina, Tennessee, West Virginia, Ohio, Michigan, Illinois, Kentucky, Indiana and Wisconsin (the "Targeted States")) in operations or permits or for maintaining compliance with $SO_2$ emissions requirements pursuant to Title IV of the Clean Air Act. The penalty is called "an air pollution mitigation offset" and equals any sum received in the sale or trade of the Select Allowance.

The New York law has been challenged. The plaintiff claims it violates the Supremacy Clause of Article VI as well as the Commerce Clause of the United States Constitution (Clean Air Markets Group v. Pataki, 00-CV-1738, U.S. District Court, Northern District where it is pending). It is possible to construct an argument (whether a winning argument or not is purely conjecture) that by limiting the use of certain $SO_2$ emission allowances, some allowances were diminished in value and that wholesale adoption of similar regulatory structures would result in the Balkanization of the allowance market and potentially damaging financial consequences to some companies who acquired non-tradable or partially tradable allowances.

The plaintiff goes on to argue that using allowances without restriction under Title IV was intended by Congress and the restrictive New York law injures the plaintiff in various ways, including but not limited to: (a) reducing the value of Select Allowances and (b) restricting the supply of $SO_2$ emission allowances available to electric generating facilities located in the Targeted States.

This action is of concern to many emission traders because the market will differentiate among allowances, enhancing the value of some allowances and diminishing the value of others.

While the Clean Air Act (see the adjoining box) declares an allowance allocated under this Title IV is a limited authorization to emit sulfur dioxide and such allowances do not constitute a property right, two questions arise. First, if it looks like a property and is treated like a property, is it the functional equivalent to property and if so, is this functional equivalent subject to similar, if not identical, protections as property? Second, can a statute limit a constitutional right? Interesting questions for emissions trading, for market-based regulatory programs, and for society as a whole.

> SEC. 403. SULFUR DIOXIDE ALLOWANCE PROGRAM FOR EXISTING AND NEW UNITS.
>
> (f) Nature of Allowances.- An allowance allocated under this title is a limited authorization to emit sulfur dioxide in accordance with the provisions of this title. Such allowance does not constitute a property right. Nothing in this title or in any other provision of law shall be construed to limit the authority of the United States to terminate or limit such authorization....Allowances, once allocated to a person by the Administrator, may be received, held, and temporarily or permanently transferred in accordance with this title and the regulations of the Administrator without regard to whether or not a permit is in effect under title V or section 408 with respect to the unit for which such allowance was originally allocated and recorded. Each permit under this title and each permit issued under title V for any affected unit shall provide that the affected unit may not emit an annual tonnage of sulfur dioxide in excess of the allowances held for that unit.

## Offsets

Emissions offsets were initially developed in 1976 and introduced within the Clean Air Act in 1977. Since then, the law of the United States has been that all new sources and major modifications in non-attainment areas had to acquire emission offsets to compensate for new emissions. What happens if your company has over-controlled emissions and banked those emissions because you relied on two facts: (1) the Clean Air Act mandates a market for offsets and (2) you have watched prices for offsets increase in certain non-attainment areas and then the offset requirement is waived. You had an asset, it had value, but after waiving the offset requirement, your asset might have diminished value. Is this the functional equivalent of a taking? Perhaps yes, perhaps no. Is such a possibility likely?

Imagine a second offset situation. In order to supply emission offsets, a community changes the offset rules to create what we will call a fee-in-lieu-of-offsets system. Under this system, the local regulator imposes additional emission controls on certain sources and resells these reductions to new sources. Imagine that the emission reductions cost $50,000 but are sold for $30,000. Does this action -- targeting some sources for emission reductions for the benefit of others -- constitute a taking and do the over-controlled sources have rights for the full “value” of their reductions?

## Greenhouse Gas Emission Reductions

There have been more than a few greenhouse gas reduction (not credit) transactions. Most, if not all, of these transactions have taken place under

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informal agreements. There are no clear international rules and it is questionable as to whether any country has greenhouse gas trading programs. If the trade in reductions does not result in trade of useful credits, is there any claim at all for a takings? For this author the claim seems modest, at best. However, clever minds might be able to make a showing that in some communication, some government action has expressed or implied attributes that look like property rights for these traded greenhouse gas reductions. For example, does the existence of a registry imply the existence of property, and if yes, what is the nature of that property? Obviously the conditions that would support demonstrating a "takings" varies from country to country since property rights vary across countries. Still, these implications are of more than idle curiosity.

Property rights based on environmental programs are subtle. They seem logical, because they are. They seem simple to develop, but they are not. They seem to be good for regulated entities and society as a whole, and they are. Nevertheless, there are serious implications associated with the development of these systems and consequences to account for when uses of these rights are limited or curtailed.

Interesting constitutional questions attend the development of trading programs. A key constitutional question is whether individual legislatures can take away property rights that grow and evolve through the developing markets. Regardless of the outcome of lawsuits now based upon Supremacy and Commerce clause claims, further constitutional questions will inevitably arise when treaties (such as the Kyoto Protocol) define trading programs. Ratified treaties under our constitutional system are superior to all legislative enactments. Will international conventions create new property that will receive constitution protection regardless of individual or conflicting congressional pronouncements deeming tradeable allowances as non-property?

**Evolution Markets has no position or "property interest" on any existing or proposed legal action on or regarding taking claims. In addition, Evolution Markets has no policy position on the complex issue. Evolution Markets LLC is interested in promoting the use of market-based regulatory programs. Your comments are welcomed.**

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