

April 2009

www.klgates.com

Authors:**Barry M. Hartman**

barry.hartman@klgates.com

+1.202.778.9338

John F. Spinello

john.spinello@klgates.com

+1.973.848.4061

Susan B. Geiger

susan.geiger@klgates.com

+1.202.661.3818

N. Akilah Green

akilah.green@klgates.com

+1.202.661.3752

K&L Gates comprises approximately 1,900 lawyers in 32 offices located in North America, Europe, and Asia, and represents capital markets participants, entrepreneurs, growth and middle market companies, leading FORTUNE 100 and FTSE 100 global corporations, and public sector entities. For more information, please visit www.klgates.com.

Winds Change for the Maritime Industry with New Climate Change Legislation

Climate change negotiators from around the world met in Bonn, Germany this month to begin hammering out a global strategy for reducing greenhouse gas (“GHG”) emissions, which many believe contribute to climate change. Discussions in Bonn included strategies for reducing GHG emissions that result from maritime shipping. At the same time, in the United States, the maritime industry finds itself the target of a new congressional effort to reduce domestic GHGs. Specifically, the Waxman-Markey discussion draft of the “American Clean Energy and Security Act,” released on March 31st, would mandate a reduction in domestic GHG emissions by 83 percent below 2005 levels over the next 40 years. To accomplish this, the proposed legislation would amend the U.S. Clean Air Act (“CAA”) to give the federal Environmental Protection Agency (“EPA”) sweeping new authority to regulate GHGs, including mandatory changes in marine fuel and engine standards, and the discretion to extend these requirements to oceangoing vessels (“OGVs”). These new mandates on marine fuel and engines would be in addition to the major changes adopted by EPA and the International Maritime Organization (“IMO”) last year to reduce vessel emissions of sulfur and nitrogen oxides. For more information about the current EPA rule governing GHG cap and trade, see, “Reporting Rule and So Much More: Setting the Stage for Cap and Trade for U.S. and International Trading Transactions” at <http://www.klgates.com/newsstand/detail.aspx?publication=5641>.

According to the EPA, transportation sources are responsible for approximately 27 percent of the total U.S. GHG emissions – the largest single category of sources in the United States. Of this amount, about 19 percent comes from heavy-duty trucks and another three percent from boats and vessels. These figures do not include GHGs emitted outside of U.S. ports. The IMO estimates international maritime shipping accounts for 2.7 percent of global anthropogenic GHG emissions, and when combined with domestic shipping, vessel emissions represent 3.3 percent of all GHGs emitted globally. Carbon dioxide is by far the most prevalent of the GHGs and is formed and emitted into the atmosphere mainly through the combustion of fossil fuels. Other GHGs emitted by the transportation sector include hydrofluorocarbons (“HFCs”) emitted from mobile air conditioners and refrigerated transport; HFCs were phased in for these uses as substitutes for banned ozone-depleting substances, such as freon.

This proposal presents unprecedented and unique challenges for the maritime industry because (a) unlike other regulated sources of GHGs, the maritime industry is not exclusively located within U.S. boundaries; (b) most fuel used by the maritime industry is not purchased from U.S. sources; (c) vessels may only spend a fraction of a voyage in the United States; and (4) vessels can move from port to port and between and among areas with differing levels of compliance with air quality standards.

Below is a summary of key provisions in the “American Clean Energy and Security Act” and a brief discussion of the issues that they raise for the maritime industry.

GHG Emissions Standards for the Maritime Industry

The discussion draft directs the EPA to set emissions standards for new marine vessels and locomotives, and for new engines used in marine vessels and locomotives, by the end of 2012. These new limits would be based on “the greatest degree of emissions reductions achievable based on technology available when the standards take effect, taking into account cost, energy, and safety.” The concept of including technology-forcing standards as a means of achieving reductions of pollutants is not new in the environmental arena. Such standards exist under both the CAA and the Clean Water Act, but compliance with future technological performance standards that are set well beyond contemporaneously achievable levels can be costly, burdensome, or even infeasible, if not designed appropriately.

Controlling GHG emissions from marine vessels is complicated by the fact that foreign trade has grown dramatically in recent decades, a significant portion of GHG emissions from OGVs occurs in international waters, many OGVs are not registered in the United States, and many vessel owners or operators do not purchase their fuel from U.S. producers. The maritime industry has therefore advocated an international approach to GHG reductions as more suitable for this community. The IMO is currently undertaking an analysis of GHG reduction measures for OGVs that may be presented later this year in United Nations-led efforts to develop a post-Kyoto global agreement for further GHG reduction.

Restricting GHG emissions from OGVs via U.S. climate change legislation, as opposed to international treaties, also raises concerns about the economic and diplomatic impact of such domestic measures on free trade and global competition and demands careful integration with international efforts.

Cap-and-Trade Program

The draft legislation allows the EPA Administrator to establish a cap-and-trade program for mobile sources, including marine vessels, which would begin by creating a limit or “cap” on the total amount of GHG emissions that will be allowed,

usually expressed in tons per year. The emissions allowed by the cap are divided into permits or credits that give the owner the right to emit certain amounts of GHGs. Over time, the overall size of the cap is reduced as is the amount of GHGs that may be emitted from each source. In the meantime, if the owner of the right to emit certain GHGs can remain under his or her limit, he or she can sell, bank, or trade the excess GHG credits within or across classes or categories of regulated mobile sources. A source that is unable to stay within its cap can purchase excess credits from others, thus creating a market-based approach to regulating GHGs. These markets currently exist under the CAA for sulfur dioxide and certain other regulated pollutants. The concept behind a cap-and-trade program is fairly simple, but the particulars are complex and raise several important design questions:

- At what level should the emissions cap be set?
- To which vessels would it apply?
- How will GHG emissions be measured? Will each source have to develop and install monitoring devices on every source of a GHG?
- Would emission allowances be auctioned or allocated? (Distribution of emissions allowances is among the most controversial components in a cap-and-trade debate because of their ability to transfer billions of dollars of wealth across different sectors.)
- Would the compliance costs of such a program be unduly burdensome to the inherently mobile maritime industry?
- How would the revenue raised by auctioning allowances be spent? Will it be returned to sources regulated under the cap to help defray the cost of compliance? Will it be used for research, development, and deployment of energy-efficient shipping equipment? Will it be used for unrelated purposes such as providing tax cuts for some?
- How would a cap-and-trade program in the United States fit with international efforts? Would it create conflict or synergies?

SmartWay Transport Partnership Program

The discussion draft also authorizes the EPA to establish a “SmartWay Transport Partnership” program with shippers and carriers of goods, which includes certifying the energy and GHG performance of participating freight carriers, including marine participants. EPA would be required to publish a comprehensive energy and GHG performance index of freight modes and individual freight companies “so that shippers can choose to deliver their goods more efficiently.” While advocates of the proposed program would encourage this certification as a way to promote energy efficiency, others contend that establishing transportation efficiency standards is sufficient.

Low-Carbon Fuel Standard

The draft establishes a new low-carbon transportation fuel standard by requiring the reduction of the lifecycle emissions intensity of transportation fuels used in motor vehicles, motor vehicle engines, nonroad vehicles, nonroad engines, and aircraft. Between 2014 and 2022, refiners, blenders, and other fuel providers would be required to ensure that the annual average lifecycle emissions from fuel sold in the United States are no greater than they were in the 2005 “baseline” year. Between 2023 and 2030, carbon emissions would be required to be reduced by at least five percent below the baseline, while from 2030 onward carbon emissions would be reduced by at least 10 percent below the 2005 baseline.

The proposal gives the EPA Administrator discretion to include fuel used in OGVs. Given the amount of GHGs emitted by OGVs, the Administrator may decide to include such fuels into the baseline. OGVs have historically used bunker fuel but are required to transition from bunker fuel to lighter, cleaner fuels over the next decade under new requirements adopted by the IMO last year in amendments to MARPOL Annex VI. The discussion draft could result in the imposition of further requirements on the fuel used in OGVs, depending upon how the Administrator exercises her discretion. The EPA’s action may depend upon the adequacy of GHG reduction measures for OGVs that are incorporated into global agreements under the

auspices of the IMO, the United Nations Framework Convention on Climate Change.

Additionally, most GHGs are emitted as a result of fuel combustion; however, approximately 20 percent of GHGs accounted for in the lifecycle analysis of fuels can come from source-specific emissions, which may have an effect on preferred sources. For example, crude oil extraction from Nigeria or Canadian oil sands produces greater GHG emissions than crude oil extracted from Venezuela or Saudi Arabia. If importers begin shifting crude oil purchases to sources with fewer GHG emissions, trading patterns and the resulting voyage patterns could be affected.

The Role of the States

The climate change debate will once again raise the issue of whether federal legislation should preempt efforts by state and local governments to curb GHG emissions and presents unique challenges for the maritime industry. While the international approach to regulating maritime GHGs has uniformity and consistency as its hallmark, U.S. legislation often allows states to set their own standards. The discussion draft would preempt states from implementing their own emissions caps from years 2012 through 2017 and then retains states’ authority to address emissions of GHGs after 2017. Additionally, the bill would require that each state submit a plan for addressing GHG emission reductions in the transportation sector, which must address the role of mobile sources. In developing its plan, a state must consider certain reduction strategies, including short sea shipping, as well as the use of retrofit technologies and early replacement of vehicles, engines, and equipment from existing mobile sources. While some stakeholders support allowing states to set more stringent GHG standards than what might be permitted under federal cap-and-trade legislation, such a patchwork could also significantly undermine the development of markets for trading. Opponents contend that separate state approaches would raise compliance costs and translate into a number of potentially conflicting reduction requirements.

Citizen Suits for Injury from Air Pollution

The bill significantly expands the grounds upon which “citizen suits” may be brought. Specifically, the bill would permit any citizen who has “suffered, or reasonably expects to suffer, a harm” to bring a suit against any person who is believed to be responsible for a violation of an emission standard or limitation to which the harm can be attributed. “Any person” would include the EPA, as well as vessel owners and operators. The term “harm” includes “any effect of air pollution (including climate change), currently occurring or at risk of occurring, and the incremental exacerbation of any such effect or risk that is associated with a small incremental emission of any air pollutant . . . whether or not the risk is widely shared.” An “effect” or “risk” associated with any air pollutant “shall be considered attributable to the violation or failure to act at issue if the violation or failure to act slows the pace of implementation of this Act or compliance with this Act or results in any emissions of GHG or other air pollutant at a higher level than would have been emitted in the absence of the violation or failure to act.” Authorizing suits addressing climate change represents a significant expansion of judicial claims and relaxes the historical requirement that a plaintiff must show actual injury and causation before being permitted to sue.

Going Forward

Congressman Henry Waxman (D-CA), the principal sponsor of this proposed climate change legislation, has set an aggressive schedule for considering the bill, beginning with hearings the week of April 20th, subcommittee markups the week of April 27th, and a goal of sending the legislation to the House floor by Memorial Day. House Speaker Nancy Pelosi (D-CA), however, has indicated that this discussion draft only marks the beginning of negotiations, and it may take longer to reach consensus in the House on the best approach to addressing global warming in a fragile economic environment, particularly given the momentum of other key priorities such as health care overhaul legislation. In any case, members of Congress plan to spend the coming weeks and months crafting legislation to address the concerns of various stakeholders, including industry, environmental, labor, faith-based, and regional groups – many of whom have competing interests. Senate Democrats, who have not yet released a draft plan and will have more difficulty coming up with the votes necessary to pass climate change legislation in their chamber, intend to take lessons from the climate change debate in the House.

No matter the pace at which the legislation is considered, the maritime industry is now clearly one of the targets in the GHG debate.

K&L Gates comprises multiple affiliated partnerships: a limited liability partnership with the full name K&L Gates LLP qualified in Delaware and maintaining offices throughout the U.S., in Berlin and Frankfurt, Germany, in Beijing (K&L Gates LLP Beijing Representative Office), in Singapore (K&L Gates LLP Singapore Representative Office), and in Shanghai (K&L Gates LLP Shanghai Representative Office); a limited liability partnership (also named K&L Gates LLP) incorporated in England and maintaining our London and Paris offices; a Taiwan general partnership (K&L Gates) which practices from our Taipei office; and a Hong Kong general partnership (K&L Gates, Solicitors) which practices from our Hong Kong office. K&L Gates maintains appropriate registrations in the jurisdictions in which its offices are located. A list of the partners in each entity is available for inspection at any K&L Gates office.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2009 K&L Gates LLP. All Rights Reserved.