Preserving the SO_2 market

Norman Fichthorn and **Allison Wood** review the recent challenge mounted by New York State against the US market in sulphur dioxide allowances

The US District Court for the Northern District of New York recently struck down a New York State law that affected the US market for sulphur dioxide (SO_2) allowances. In *Clean Air Markets Group v Pataki*,* the court ruled that New York's law violated the Supremacy and Commerce Clauses of the US Constitution.

New York enacted the anti-trading law in May 2000 with the purported goal of reducing acid rain in New York's "environmentally sensitive" areas such as the Adirondack Mountains. The law affected what it called "select credits" – those SO_2 allowances originally issued by the Environmental Protection Agency (EPA) to New York electricity generators under Title IV of the Clean Air Act (the federal Acid Rain Program). The New York law effectively prohibited the sale of select credits to 14 targeted 'upwind' states (Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia, and Wisconsin). If a select credit ultimately was used for Title IV compliance in any of these states, the seller would forfeit to New York 100% of the sale proceeds for that allowance. Only allowances with a 'restrictive covenant' preventing their use in the 14 states were exempt from the forfeiture requirement.

As New York was considering enactment of its law, the Emissions Marketing Association expressed concern to the EPA about the effect that such a law would have on the nationwide, interstate SO_2 allowance market created by Congress when it enacted Title IV in 1990. Addressing the association's concerns, EPA assistant administrator Robert Perciasepe stated that "EPA believes that the market-based mechanisms in the current programme are working effectively and does not support the proposed restrictions on the use of SO_2 allowances". Despite these concerns, New York enacted the law.

New York's action disrupted and balkanised the allowance market, which saw a drop in the value of New York allowances after the law was enacted. Letting the law stand unchallenged would only have invited other states to follow New York's lead and created more chaos in the market. Therefore, the Clean Air Markets Group (CAMG) – an association of generating companies, allowance brokers, mining companies, and trade associations that seek to promote market-based environmental incentives – filed a lawsuit against the governor of New York and the members of the state's Public Service Commission (the body with responsibility for administering the New York law).

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CAMG argued that the law should be struck down because it violated two bedrock provisions of the US Constitution: the Supremacy Clause, which declares that state law cannot interfere with federal law; and the Commerce Clause, which prohibits states from impeding the free flow of interstate commerce within the US.

On 9 April 2002, the federal district court ruled for CAMG, finding the New York law unconstitutional on both grounds. The court held that the law unlawfully interfered with the national SO_2 allowance market intended by Congress because it walled off 14 states from the market in allowances allocated by federal law to New York sources. Thus, the court concluded, federal law – ie, Title IV – preempted New York's law. The court also held that the state's law impermissibly interfered with interstate commerce in SO_2 allowances. The court declared the law "null and void" and ordered New York to take no steps to enforce it. New York has appealed the district court's decision to the US Court of Appeals for the Second Circuit, which will likely issue its decision next year.

This case underscores the importance of counteracting misperceptions about broad-based emissions markets. Title IV has resulted in greater reductions in SO_2 emissions due to its direct economic incentives to reduce emissions early and beyond required levels. Phase I of the Title IV programme (1995–99) resulted in actual SO_2 emissions in the US about 30% less than allowable limits. The US General Accounting Office documented a 26% decline in wet sulphate deposition – a key component of acid rain – in New York's Adirondacks in 1995–98 compared to 1983–94. Phase II of the programme, which began in 2000, is driving emissions down even further. Moreover, New York's law, while disrupting the interstate market and eliminating a critically important feature of allowances – their fungibility – could not be shown to do anything to reduce acid rain, a point that CAMG and the district court noted. To avoid the problems posed by counter-productive legislation like New York's, it will be important for the public – and their elected representatives – to gain a balanced understanding of the economic and environmental benefits of market-based emissions trading.

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* The court's opinion is at 194 F. Supp. 2d 147 (N.D.N.Y. 2002), and can be found at: www.nysd.uscourts.gov/courtweb/pdf/D02NYNC/02-03325.PDF

The Emissions Marketing Association consists of more than 270 members from 190 companies worldwide. Its aim is to promote market-based trading solutions for environmental control

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