

## California's LCFS Surviving Challenges As Major Changes Loom

### The Air Resources Board proposes to merge court-mandated re-adoption of the Low Carbon Fuel Standard with other significant program changes.

The [Low Carbon Fuel Standard \(LCFS\)](#) continues to generate uncertainty due to enduring legal challenges and the California Air Resources Board's (ARB) intention to alter the program to prevent market shortages. On March 20, 2014, in a federal proceeding challenging the constitutionality of the LCFS, industry groups filed petitions for certiorari with the US Supreme Court. Invalidation by the US Supreme Court could not only destabilize the LCFS but also cast doubt on the constitutionality of other California programs that regulate greenhouse gas (GHG) emissions attributable to out-of-state activities. In a separate state case, when the California Supreme Court denied a petition for review from ARB last November, it kicked-off an ongoing process whereby ARB must readopt the LCFS on a state court-mandated schedule or face suspension of both the operation and enforcement of the program. In conjunction with this re-adoption of the LCFS, ARB also is preparing major changes to the program that would flatten the program's carbon intensity (CI) reduction schedule, alter the CI values of certain biofuels, provide LCFS credit generation opportunities for petroleum refineries and crude oil producers, and provide a compliance cost containment mechanism. On March 11, 2014, ARB held [public workshops](#) to discuss these [proposed updates](#). Affected entities should continue to monitor these developments and consider engaging ARB on the proposed LCFS reforms.

### Synopsis

The California Supreme Court recently declined to review a Court of Appeal decision requiring ARB to correct procedural defects in its promulgation of the LCFS. Accordingly, ARB must now fix and reapprove the LCFS. The LCFS remains in effect in the interim, though frozen at 2013 CI standards, and only so long as ARB sets a realistic re-adoption schedule and meets it.<sup>1</sup> If ARB fails to "proceed in good faith and without delay," the Fresno County Superior Court will suspend the LCFS.

The LCFS also recently survived a Ninth Circuit Court of Appeals challenge alleging that the LCFS violates the dormant Commerce Clause of the US Constitution. However, petitioners have appealed to the US Supreme Court, which may grant certiorari on issues flagged by Ninth Circuit judges dissenting from the denial of rehearing en banc. If the US Supreme Court denies certiorari, there remains one more constitutional hurdle for the LCFS to clear, albeit a relatively low one, at the federal District Court on remand.

Amid the state and federal litigation, ARB appears poised to consolidate the court-mandated re-adoption proceeding with other planned updates, which together are designed to remedy the court-identified legal infirmities and significantly change the LCFS program. ARB staff is proposing a suite of amendments to provide a stronger signal for investments in and production of the cleanest fuels, offer additional compliance flexibility, update critical technical information, and provide for improved efficiency and enforcement of the regulation. ARB plans to work on the rulemaking throughout the spring and summer,

including by holding public workshops and meetings with individual stakeholders, and finalize a revised LCFS this fall.

Against this backdrop, industry has become increasingly vocal regarding certain elements of the LCFS and the program's overall ambitions. For example, the Western State Petroleum Association has relied on economic projections prepared by various research firms — including the Boston Consulting Group — which point out that the LCFS credit market may become short sometime after 2015. The run up in LCFS credit prices prior to the judicial decisions analyzed herein suggest that these projections are accurate. Although the flattening of the CI reduction curve — as required by the current legal challenges — will delay any market shortage and provide additional time for innovation and technical improvements, concerns remain that the market will be unable to deliver the level of carbon reductions required by the LCFS — even under increased gasoline prices.

## State Litigation

On November 20, 2013, the California Supreme Court [denied](#) a petition from ARB seeking review of the Fifth District Court of Appeal's July 15, 2013, order requiring ARB to reopen its LCFS rulemaking. Plaintiffs in *POET, LLC et al. v. California Air Resources Board et al.* had challenged the LCFS on various procedural grounds. In denying ARB's petition, the Supreme Court left intact the Court of Appeal's decision, which held that ARB's adoption of the LCFS violated requirements of the California Environmental Quality Act (CEQA) and the California Administrative Procedure Act (APA). While technically defeats for ARB, the California courts' actions allow the LCFS to remain in force. The [Court of Appeal concluded that the challenged LCFS regulations should remain in effect while ARB cures the CEQA and APA defects](#). The court reasoned that "the environment will be given greater protection" with the LCFS in effect, concluding: "[W]e will avoid the irony of violations of an environmental protection statute being used to set aside a regulation that restricts the release of pollutants into the environment." Because the court's decision maintains the status quo, the 2014 LCFS standards did not phase in on schedule, so the 2013 LCFS standards remain in effect. See our [July 2013 Air & Climate Forecast](#) for more details on the decision in *POET*.

Under the supervision of the Fresno County Superior Court, which ruled in ARB's favor on the LCFS in November 2011, and pursuant to the Court of Appeal's order, ARB is now required to:

1. Assign a decision-maker with authority to approve or disapprove of the proposed LCFS regulations and to complete CEQA review
2. Adequately consider biodiesel NOx emissions impacts and, if necessary, adopt appropriate mitigation measures
3. Hold a 45-day public comment period, with specific attention to the CI assigned to land use changes
4. Include previously excluded emails from ARB consultants in the administrative record that question the defensibility of the carbon emissions ARB attributes to ethanol-related land use changes

The Fresno County Superior Court, pursuant to a peremptory writ of mandate, will maintain jurisdiction over ARB's administrative proceedings. The writ, filed February 10, 2014, provides that so long as ARB "proceed[s] in good faith without delay" in complying with its terms, the LCFS regulations will remain in effect under the 2013 standards. However, if ARB does not so proceed, the Superior Court may set aside and "suspend the operation and enforcement of the regulations." The parties currently are engaged in briefing regarding ARB's Proposed Initial Return to the Writ. If the Court is satisfied with ARB's proposed schedule and process for re-adopting the LCFS and remedying the CEQA and APA infirmities, then the

LCFS may remain in force with the 2013 standards in place until ARB finalizes the re-adoption process. If the court finds that ARB is not proceeding in good faith or is delaying, then the court may immediately suspend the LCFS. The Superior Court is expected to issue an order in connection with the Initial Return in the coming weeks.

## Federal Litigation

The LCFS also has survived, so far, another legal challenge. On September 18, 2013, the Ninth Circuit issued an [opinion](#) in *Rocky Mountain Farmers Union v. Corey*, 730 F.3d 1070 (9th Cir. 2013), upholding the LCFS, reversing a lower court ruling that the LCFS facially discriminated against interstate commerce in violation of the US Constitution, and remanding the case to the lower court for further proceedings.

Plaintiffs — including ethanol, farming, petrochemical, energy and trucking industry groups — argued that the LCFS program’s “lifecycle analysis” impermissibly regulates beyond state lines and discriminates against ethanol and crude oil produced out-of-state, in violation of the dormant Commerce Clause. In December 2011, a district court granted plaintiffs’ request for a preliminary injunction, but the court stayed the injunction — which would have otherwise prevented implementation of the LCFS — pending resolution of ARB’s appeal. The Ninth Circuit’s recent decision rejected the plaintiffs’ arguments, overturned the lower court’s decision and vacated the District Court’s injunction. Accordingly, the LCFS remains in force.

On January 22, 2014, the full Ninth Circuit en banc [denied](#) a petition for rehearing. *Rocky Mt. Farmers Union v. Corey*, 12-15135, 2014 WL 223797 (9th Cir. 2014) (Denial of Request for Rehearing). However, seven judges issued a dissent that may attract Supreme Court review. Judge Milan Smith’s dissent asserts that the LCFS is facially discriminatory because it “explicitly treats in-state and out-of-state ethanol differently in calculating carbon intensity,” and the dissent cites Supreme Court precedent for the proposition that “[t]he purpose of, or justification for a law has no bearing on whether it is facially discriminatory.” For Judge Smith and six other Ninth Circuit judges, in determining whether the LCFS is facially discriminatory — a determination that would trigger a strict standard of review that is very difficult to satisfy — it is irrelevant that the distinction between in-state and out-of-state fuels may have a legitimate basis in CI and does not result from discriminatory motive or intent.

Judge Ronald M. Gould, author of the panel’s majority opinion, concurred in the denial of rehearing en banc and characterized the dissent as “riddled with overstatements” and “alarmist rhetoric.” He also described the test for facial discrimination differently than Judge Smith. “A legislative geographic distinction is not facially discriminatory merely because it affects in-state and out-of-state interests unequally. Rather, as long as there is ‘some reason, apart from their origin, to treat them differently,’ California may distinguish between Midwestern, Brazilian, and California ethanols.” Under *Rocky Mt. Farmers Union v. Corey*, CI and the objective factors on which it is based (including, e.g. transportation-related emissions) constitute legitimate reasons for treating in-state and out-of-state ethanol differently, and thereby the court avoided a determination of facial discrimination. However, as indicated in Judge Smith’s dissent, at least seven Ninth Circuit judges believe considering the purpose or justification for a law in determining whether it is facially discriminatory “puts the cart before the horse” and is therefore inconsistent with Supreme Court precedent.

On March 20, 2014, a number of plaintiffs filed petitions for certiorari with the US Supreme Court. If the Supreme Court denies the petitions, the case would be remanded to the District Court for review under a more relaxed dormant Commerce Clause standard, the “*Pike* balancing test.” The *Pike* test — generally viewed as less stringent than the test applicable to laws that are facially discriminatory — requires only that a statute’s burdens on interstate commerce not be clearly excessive in relation to the in-state

benefits. If the Ninth Circuit's opinion is any indication, more likely than not the LCFS would pass this test on remand.

## **Proposed Changes to the LCFS Program**

On March 11, 2014, ARB held [public workshops](#) to discuss [proposed updates](#) to the LCFS regulation and indirect land use change values, which affect the CI values of certain fuels (e.g. corn-based ethanol). Through these proceedings, ARB will attempt to remedy the CEQA and APA violations identified by the Court of Appeal in *POET* and institute potentially significant changes to the LCFS program.

### ***Credits for GHG Emission Reductions at Certain Refineries***

ARB staff is proposing to allow refineries to generate LCFS credits via investments that reduce GHG emissions. The LCFS focuses on CI, which is a measure of the GHG emissions associated with the "life cycle" of a transportation fuel (i.e., production, distribution and consumption/combustion). Emissions attributable to refining historically have been included in the CI of a given fuel. But rather than reduce the standard CI of gasoline (CARBOB) and CARB diesel, ARB proposes to recognize stationary source GHG emission reductions at refineries by issuing LCFS credits. Refineries would submit an efficiency project plan to ARB for approval, and staff would determine the difference between the baseline CI of the refinery's transportation fuels and the new CI of their transportation fuels with the project in place. The difference would be used to calculate LCFS credits for the refinery, and these credits would be eligible for sale to other regulated parties.

Interestingly, this proposal would provide a much-needed new potential source of credits for refineries and would incentivize investments in new efficiency projects. Apparently, however, if not implemented properly the proposal could also send the wrong signal to industry because the proposed program would reward those companies that have neglected making investments in their assets. To make an analogy with the Cap-and-Trade Program, one could argue that this would be the equivalent of allocating free allowances on the basis of historical emissions at a covered source. ARB specifically rejected this approach in favor of an efficiency methodology explicitly to avoid creating a perverse incentive to maximize receipt of free allowances.

### ***Modified Compliance Schedule***

ARB staff is proposing to modify the compliance schedule for gasoline and diesel standards to account for the delay in phasing in the 2014 standards. Because the *POET* case has frozen CI standards at 2013 levels, and the re-adoption proceeding will not likely conclude until late 2014 or early 2015, ARB staff believes that some post-2015 "curve-smoothing" will be appropriate. ARB staff currently has no proposal to change the average CI target of 10 percent by 2020, but staff is conducting an in-depth analysis of projected fuel availability that will inform the 2016-2020 compliance targets. This flattening partially stabilized LCFS credit prices. Some market participants, however, view this flattening as insufficient to address the market's perceived structural inability to deliver a supply of clean fuels that will meet the program's increasing stringency.

### ***Cost Containment***

ARB staff also is proposing to adopt a cost containment provision to increase market certainty about the maximum costs of compliance and provide additional compliance options. Staff has proposed two options: (1) a credit clearance option; and (2) a credit window option. The credit clearance option would allow regulated entities to carry over deficits so long as they purchase credits during a "credit clearance" period at the end of each compliance period. Under the credit window option, regulated parties would have the option of purchasing compliance-only credits directly from ARB at a pre-determined price. ARB

staff suggests that the credit clearance option is the preferred option for minimizing credit shortages and price spikes. This welcome proposal would address potential spikes in the price of LCFS credits. As with the measures contained in the Cap-and-Trade Program, however, this containment proposal does not constitute a true price ceiling, and as such may just postpone the need to address structural issues affecting the market.

### ***Revised Indirect Land Use Change Values***

Indirect Land Use Change (iLUC) values for corn ethanol, sugarcane ethanol, and soy biodiesel were included in the LCFS as originally approved in 2009 and 2010. The science on iLUC values has evolved since then. Accordingly, ARB staff plans to refine the iLUC analysis. ARB staff suggested the board may reduce the iLUC values for soy biodiesel, sugarcane ethanol and corn ethanol. ARB staff is proposing newly developed iLUC values for canola biodiesel and sorghum ethanol. The proposed changes also include a new model for assessing the carbon released upon land conversion.

*POET* required ARB to hold a public proceeding to adequately consider the CI values associated with iLUC.

### ***Innovative Technologies for Crude Oil Production***

ARB is proposing that crude oil producers be permitted to opt-in as regulated parties under the LCFS and earn LCFS credits for innovative production, if producers employ techniques that reduce their GHG emissions. Currently, the LCFS awards credits to refiners who purchase crude oil produced in an innovative manner. If adopted, the proposed change could increase the incentives for crude oil producers to innovate. For example, using solar power to generate steam to replace natural gas generators could earn oil producers LCFS credits for reductions in the CI of downstream transportation fuels.

### ***Other Developments***

ARB staff has proposed a number of technical changes relating to CI calculation for smaller California refineries, certification and registration of regulated entities, reporting procedures for LCFS credits, and reporting and recordkeeping requirements. Enforcement provisions also will be considered, with an emphasis on ensuring that noncompliance costs more than compliance with the LCFS standards.

Finally, in a related proceeding, on March 14, 2014 ARB withdrew a rulemaking to regulate NO<sub>x</sub> emissions from biodiesel fuels, an issue addressed in *POET*. ARB's proposed biodiesel rule, which had been scheduled for adoption at ARB's March 20 board meeting, would have regulated biodiesel commercialization to protect public health and air quality. The proposed rule included mitigation measures applicable to biodiesel blends that would cause significant increases in NO<sub>x</sub> emissions. ARB had proposed to consider additives, cleaner base fuels and blend limits as potential NO<sub>x</sub> mitigation measures. ARB plans to re-propose the biodiesel rulemaking this summer.

## **Conclusion**

To date, California's LCFS has weathered a number of judicial challenges. ARB is pushing ahead with implementation and is preparing to adopt a number of significant changes to the LCFS program. Indeed, based on statements in the [Proposed Update to the AB 32 Scoping Plan](#), ARB already is looking to extend the LCFS Program to 2030.

However, the US Supreme Court may grant certiorari in the *Rocky Mountain* case and could invalidate the LCFS. The case presents an opportunity for the Supreme Court to address significant jurisprudential questions around what constitutes facial discrimination under the dormant Commerce Clause. If the

Supreme Court grants review and invalidates the LCFS, the decision would not only undermine California's efforts to curb emissions attributable to transportation fuels, it could also raise serious constitutional doubt as to the validity of other ambitious state programs designed to reduce GHG emissions. For example, the California Cap-and-Trade Program's regulation of electricity imports from neighboring states could be affected.

In the meantime, the LCFS is operable and will continue to remain in force, so long as the Fresno County Superior Court is satisfied that ARB is moving forward in good faith and without delay. Latham & Watkins Environment, Land and Resources Department attorneys continue to track implementation of the LCFS and are available to advise on opportunities to interface with ARB.

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**Endnote**

<sup>1</sup> The LCFS aims to reduce the CI of transportation fuel sold in California by ten percent by 2020 and is a core component of California's GHG reduction strategy.