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LEGAL ISSUES RELATED TO CREATION, BANKING AND USE OF EMISSION REDUCTION CREDITS (ERCs)

PART I: The "Taking" Issue--Is Compensation Required if a State or Local Government Confiscates or Reduces the Quantity of Banked ERCs?

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PART I: The "Taking" Issue -- Is Compensation Required if a State or Local Government Confiscates or Reduces the Quantity of Banked Emission Reduction Credits?

A. INTRODUCTION AND SUMMARY

EPA policy under the Clean Air Act lets private entities "bank" emission reductions for future use or sale, so long as reductions are in excess of those required by law and meet certain other requirements. "Banking" refers primarily to state or local government certification of an excess reduction as usable in the future to satisfy an emission reduction requirement. Certification gives the creator of the excess reduction a contingent property right in the form of an Emission Reduction Credit (ERC). The ERC can be used as a new source offset, in certain netting transactions, or in a bubble to satisfy current or new reduction requirements imposed by a control agency on existing sources. The ERC can be used by its creator, sold for use by another pollution source, or sold to a third party that may hold it for investment purposes.

Each state or local government that establishes a banking system will set out rules for creation, transfer and use of ERCs.

In controlling air pollution, state and local governments may determine that reductions beyond those imposed by current regulation are necessary. The need for further regulation could arise, for example, from discovery that the current State Implementation Plan (SIP) is inadequate to attain ambient standards by the applicable deadline or from conclusions that projected emissions growth will violate a PSD increment or threaten an area's attainment status.

Some control agencies with banking systems may decide to fill a portion of their need for additional reductions from banked ERCs. This approach is not required by the Clean Air Act; the control agency could require existing sources to achieve the needed reductions. Nonetheless, banked ERCs could be seen as a convenient source of further reductions.

There is no question about the fundamental right of states or local governments to "take" banked ERCs, so long as they are taken for public rather than private benefit. This right exists

as an exercise of eminent domain or of the police power. The issue is whether an ERC owner would be entitled to compensation from the government for the resulting loss.

This paper discusses major court cases relevant to this issue and their application to governmental action that may reduce the value of ERCs to their owners. A brief summary precedes this discussion:

The government's power to take private property in order to benefit or prevent harm to the public was established in common law that predates the U. S. Constitution. So, too, the limitation that such taking of property may require compensation was already well-established when incorporated in the Fifth Amendment to the U. S. Constitution.

The cases on the compensation issue start by distinguishing between two major bases of governmental power to take or diminish the value of private property--police power and eminent domain. Police power is the power to regulate private activity to protect public health, safety, morals and general welfare; eminent domain is the power to condemn and take private property for public use, such as to build a highway. Exercise of eminent domain almost always requires compensation, while police power regulation may only require compensation under very limited circumstances. Reducing the value of ERCs would only be an act of eminent domain if ERCs were taken to allow construction of a public facility, such as a municipal incinerator. Taking of all or a portion of a person's ERCs would otherwise be an exercise of police power, protecting public health or welfare from harm not perceived or projected at the time the ERCs were certified.

Assuming that ERCs are not taken for construction of a public facility, a court deciding the compensation issue would look to the purpose of the regulation and the extent to which regulation diminished or destroyed the value of private property (ERCs). In assessing the extent of an ERC owner's loss, a court might also examine the owner's expectations, particularly where expectations led to financial investment (that is, monetary reliance).

ERCs may be created incidentally, with little or no independent investment, or specifically for investment purposes, as by a third party who pays a polluting source to reduce emissions and hopes to sell the resulting ERC at a profit. This paper focusses on the latter situation, where monetary reliance and the likelihood of required compensation are greater.

Analysis of the compensation issue for an owner who invested in ERCs solely for profit proceeds as follows. First, courts

will give considerable deference to governmental activity that protects public health and, accordingly, the likelihood that compensation would be required is minimal. Regulation is not immune from compensation, however, and some courts might consider the extent of the loss suffered by ERC owners, their expectations and the evenhandedness of the regulatory burden. This analysis raises issues that can be met effectively in designing a banking system.

The most certain way for states or local governments to avoid the compensation issue is not to take ERCs. There may, however, be situations where control technology limitations, the severity of an air pollution problem or other factors make it infeasible to extract the necessary emission reductions from existing sources in a particular area. Thus, designers of banks should observe the following approaches:

- First, set out in the banking rules the way in which ERCs may be diminished. While judicial deference to health and safety regulation would most likely support state or local adjustments to ERCs for air quality reasons in any case, setting forth in the rules what ERC creators can expect is by far the best approach. Not only will government agencies avoid having their adjustment actions overturned, but controversy and delay will also be minimized by a clear statement of how and when adjustments would be carried out, if necessary.

- Second, make clear to creators of ERCs that their property rights are conditional and subject to diminution in the event of further regulation.

- Third, avoid "taking" <u>all</u> of any one owner's ERCs.

- Fourth, ensure that any partial "taking" of ERCs occurs evenhandedly, and in roughly the same ratio as existing sources are required to achieve further reductions.

Observance of these considerations not only will make required compensation extremely unlikely, but will also provide more planning certainty to potential investors in ERCs.

To comport with due process, any reduction in ERCs must be preceded by notice and the opportunity for a hearing. That due process requirement may, however, be satisfied by general notice and comment when the banking system itself is created on the way the administering agency plans to adjust ERCs and the criteria it will employ to decide whether adjustment is necessary.

A. SPECIFIC SITUATIONS IN WHICH ERCs MAY BE RESTRICTED OR ADJUSTED

Governments are free to guarantee in emissions trading rules against ERC adjustment, and obtain any necessary further reductions from their inventory of existing sources.[1/] Governments choosing to obtain all or part of necessary further reductions from banked ERCs could treat these ERCs in several different ways. The adjustments to ERCs could involve either restrictions on use or loss of part or all of the ERCs banked. Specific approaches include:

- a pro rata reduction in ERCs ("discounting");
- a moratorium on ERC use;
- complete confiscation of banked ERCs; and
- an increase in allowance ratios (i.e., the number of ERCs required to offset emissions from new or existing sources would be increased).

As will be discussed later, the complete confiscation of banked ERCs would be very unwise. Confiscation would not only raise the most serious possibility of required compensation, but the potential for confiscation would also strongly deter investment to create ERCs.

An ERC owner normally obtains ERCs by producing them at his or her facility or by purchasing them from another ERC owner. Five situations involving banked ERCs appear most likely:

1. A person creates and banks ERCs with the intention of using the ERCs;
2. A person creates and banks ERCs with the intention of selling them;
3. A person creates and banks ERCs incidental to some other action (e.g., plant modernization or shutdown), and holds them with no specific intention to use or sell them;
4. A person buys banked ERCs with the intention of using them; and
5. A person buys banked ERCs with the intention of reselling them.

1/ Sources with banked ERCs would not be exempt from any requirement for additional reductions, but could satisfy that requirement by using their banked ERCs, by reducing emissions elsewhere, or by purchasing equivalent ERCs.

In all but the third of these five situations, the ERCs have been produced or purchased for some specific purpose. Owners expect to be able to use or sell their ERCs in the future. This raises a very important issue regarding the type and timing of notice (or lack of notice) given by the government to potential ERC owners about the limitations on their rights.

Before turning to a discussion of law, it is well worth noting that addressing the compensation issue is entirely compatible with developing and promoting an effective banking system. Just compensation for property taken is not a legal incantation; it is rather a principle of fairness. The principle is intended to avoid unduly burdening an individual or small group by government actions that benefit or protect the general public. The principle is flexible, however, because it must not be used to deter or "dull" important government action to benefit or protect the general public. To lay the compensation issue completely to rest, governments need only design banking systems so that taking of ERCs is limited and evenhanded and ERC owners have full notice of limitations in advance of their investment. Such actions will also promote a level of certainty that is critical to the viability of any banking system.

B. THE LAW OF "TAKING"

The United States Constitution forbids the federal and state governments (1) from "taking" private property without "due process" and (2) from "taking" private property "for public use" without paying "just compensation" to its owner.[2/] These two facets of the "taking" issue have often been treated as a single "taking" issue.[3/] The due process facet requires that the government action be rationally related to a legitimate government purpose and be accomplished by generally fair procedures; the compensation facet requires that government action be fair to the affected individual.

As noted earlier, the general policy of the law of "taking" reflects an attitude that an individual should not bear the whole burden when government actions benefit the general public. Therefore, the government will pay the individual for the property "taken."

While the law of "taking" appears straightforward, the balancing tests which underlie it inevitably mean that courts

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2/ U.S. Const. Amend V. The "just compensation" provision, while not explicitly incorporated in the Fourteenth Amendment, has been extended to State as well as Federal action under the general "incorporation doctrine". See, Chicago, B. & Q. Ry. Co. v. City of Chicago, 166 U.S. 226, 236, 17 S. Ct. 581, 584 (1897)

3/ See, e.g., Haley, "Balancing Private Loss Against Public Gain to Test for A Violation of Due Process or a Taking Without Just Compensation", 54 Washington Law Review, 315, 324-326 (1979).

have had difficulty in applying it.4/ Even the United States Supreme Court has produced what appear to be conflicting decisions in this area. The apparent inconsistency may be explained in part by the opinion in a case recently decided by that Court:

> [T]his Court has generally been unable to develop any "set formula" for determining when "justice and fairness" require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons. . . Rather it has examined the "taking" question by engaging in essentially ad hoc, factual inquiries that have identified several factors--such as economic impact of the regulation, its interference with reasonable investment-backed expectations, and the character of the governmental action--that have particular significance.5/

"Taking" cases are decided on their particular facts in light of certain general propositions. The variables a court will consider when making a "taking" determination include:

- to what degree government actions are designed to create general public benefits as distinguished from actions to prevent harm to the public.
- whether the government has physically invaded private property;
- whether all, or substantially all, of the property values have been destroyed by government restrictions; and
- to what extent the government actions have interfered with reasonable investment-backed expectations.

4/ See, e.g., Andrus v. Allard, 444 U.S. 51, 65, 100 S. Ct. 318, 327 (1979). The majority wrote: There is no abstract or fixed point at which judicial intervention under the Takings Clause becomes appropriate. Formulas and factors have been developed in a variety of settings. . . Resolution of each case, however, ultimately calls as much for the exercise of judgement as for the application of logic."

5/ Kaiser Aetna v. United States, 444 U.S. 164, 175, 100 S. Ct. 383, (1979). The concept of "reasonable investment-backed expectation" seems to include several meanings. It has been applied where government action has "nearly the same effect as the complete destruction of rights [the] claimant had." It has also been interpreted as the property owner's primary reasonable expectation given the historical pattern of use for the property in question. See, Penn Central v. New York, 438 U.S. 104, 127, 136 (1978).

1. Creating Public Benefit Versus Preventing Public Harm

This distinction essentially differentiates an exercise of eminent domain from an exercise of the police power:

> Eminent domain takes property because it is useful to the public, while the police power regulates the use of, or impairs rights in, property to prevent detriment to public interest; in the exercise of eminent domain private property is taken for public use and the owner is compensated, while the police power regulates an owner's use and enjoyment of property, or deprives him of it, by destruction, for the public welfare, without compensation other than the sharing of the resulting general benefits. Constitutional provisions against taking private property for public use without just compensation impose no barrier to the proper exercise of the police power.6/

This clear statement of the distinction would seem to require only that the taking of ERCs qualify as "regulation" to avoid the compensation requirement. This is not a difficult hurdle where ERCs are taken to protect public health or otherwise comply with the Clean Air Act.7/

Indeed, regulation, and particularly health regulation, has been accorded great latitude by the courts. For a valid regulatory purpose, governments can literally destroy private property without compensation. For example, an order that cedar trees afflicted with disease called "cedar rust" be cut down did not require compensation to the cedar tree owners. The cedar rust, though not fatal to cedars, was fatal to apple trees. The state could require destruction of the cedars without compensating the owners for loss of the trees themselves or for the decreased value of the land on which

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6/ 29A C.J.S. Eminent Domain §6 See also, Note, Regulation Without Just Compensation: A Political Process-Based Taking Analysis of the Surface Mining Act, 69 Geo. L. Rev. 1083 (1981).

7/ Note, however, that if a government takes ERC's to build a government facility and create a public benefit, this action would probably be held an exercise of eminent domain with compensation required. On the other hand, taking ERC's to create a growth margin--which could be used to permit new source construction in a nonattainment area--would no doubt qualify as regulation. Creating the growth margin would be reasonably related to a valid goal--maintaining compliance with the Clean Air while promoting economic growth.

the cedars stood (Miller v. Schoene, 276 U.S. 272, 48 S. Ct. 246 (1928). The action taken was for the public good--preservation of apple trees. The Supreme Court noted that the apple industry was important in the state; the state legislature did not violate the Constitution by requiring the destruction, without compensation for the loss of one class of property to protect another class of property that was more important to the public. A case for protection of public health by destruction of ERCs would be even more compelling.

Despite the strength of the notion that regulation does not require compensation, there have been cases requiring compensation on theories relating to the remaining variables.

2. Physical Invasion

Physical invasion of property by the government, which in one case consisted only of frequent military flights over a chicken farmer's land requires compensation.[8]/ But since ERCs are intangible, not "physical," property, this variable is not relevant here.

3. Degree of Destruction

A few cases have held that government regulation which destroys all or substantially all of the value of property requires compensation. The most famous case involved a Pennsylvania statute flatly prohibiting the mining of coal so as to cause the collapse of residences, streets or other structures, even by a person owning the mineral rights.[9]/ Despite the danger to life and property created by the prohibited conduct, the Supreme Court upheld the coal company's right to mine and overturned the Pennsylvania statute as a taking without compensation.[10]/ Justice Holmes stated the following vague rule:

> The general rule at least is, that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking.[11]/

8/ Causby v. United States, 328 U.S. 256, 66 S. Ct. 1062 (1946).

9/ Pennsylvania Coal v. Mahon, 260 U.S. 393, 43 S. Ct. 158 (1922); see also Fred Bosselman, David Callie and John Banta, The Taking Issue, pp. 126-138, (Washington, DC: GPO, 1973).

10/ 260 U.S. 393.

11/ 260 U.S. 393, at 415.

While decided in 1922, this case has continuing importance in light of the very limited Supreme Court review of land use cases since the 1920s.12/

The law relating to degree of destruction of value is not particularly clear. The Court has never established what is meant by regulation going "too far." Further, the cited case allowing total destruction of cedar trees to protect apple harvests13/ was decided only six years after the Pennsylvania coal mining case. Moreover, a 1915 case indicates that regulation can destroy nearly all of the value of property.14/ There a local ordinance effectively prohibited a brickmaker from using land acquired and improved for brickmaking. Though the value of the land was reduced from about $800,000 to $60,000,15/ no compensation was required.

This line of cases suggests that banking authorities have broad power to reduce the value of ERCs, so long as they do not destroy the full value of ERCs through confiscation. In any case, confiscation is unwise on policy grounds, since it destroys the incentive to create and bank ERCs.

4. Investment-Backed Expectations

A person who invests money to create ERCs has an "investment-backed expectation" of some level of ERC security. Where government actions interfere with such expectations a "taking" may be found.16/ "Investment-backed expectations" can involve government actions that have resulted in nearly complete destruction of the property owner's rights. They can also involve the primary expectations a property owner has in terms of the historical pattern of use for the property.17/ In either case, the amount of one's expected gain becomes important when a court reviews a "taking" claim. To the extent an investor has good cause to believe the value of his property is secure, there is a greater likelihood that a "taking" will be found.

12/ See Bosselman, supra, note 8, p. 138.

13/ Causby, supra, note 7.

14/ Hadacheck v. Sebastian, 239 U.S. 394, 36 S. Ct. 143 (1915).

15/ Id.

16/ Kaiser Aetna, supra, note 4.

17/ Penn Central v. New York, 438 U.S. 104, 98 S. Ct. 2646 (1978).

It should be clear that designers of banking systems can avoid this issue by carefully defining the situations and conditions under which ERCs may be adjusted. As long as investors are not led to expect more ERC security than will exist, these investors cannot assert that ERC adjustment constitutes a "taking without compensation." There is simply no expectation--investment-backed or otherwise--that their property right in ERCs defined and limited under an overriding statute (the Clean Air Act) is absolute.

C. TAKINGS AND DUE PROCESS

The validity of an ERC adjustment will turn on the procedures employed as well as preceding compensation considerations. Procedure involves two elements--the ERC owner must be notified of the proposed adjustment and must be given some opportunity to comment on it. Failure to satisfy these procedural elements may invalidate an otherwise proper government action. However, for ERCs the requirements are easy to satisfy; SIP changes require that a hearing process be used, and notice and comment requirements for ERC adjustments can be satisfied as part of the SIP revision process. Notice and comment requirements may also be presumptively satisfied if the need for adjustments is an explicit issue in the hearings accompanying development of a banking and trading rule, and that rule expressly incorporates fair procedures for determining when, where and to what extent an adjustment of banked ERCs will occur.

D. ANALOGIES AND PRECEDENT FOR ERCs

In the early years of the Clean Air Act a source that reduced emissions more than required could neither use nor save those excess reductions for future use. The offset policy of 1976 for the first time allowed some use of such "surplus" reductions as offsets to let new sources locate in nonattainment areas, but only under stringent limitations.[18] For example, if an existing source installed an electrostatic precipitator (i.e., 90-95% control), when regulations required only 75% control (achievable by a cyclone), those excess emission reductions had to be applied immediately to meet a new source's offset requirements or they would be lost. There were no bankable credits awarded. Except for narrow "replacement" circumstances involving destruction of existing facilities to make way for new ones on the same site, all offsets had to be "contemporaneous." Those who created emission reductions and lost all or part of them because they could not be saved did not have any "taking" argument--the "right" to receive credit for excess emission reductions did not yet exist. [19]

18/ See, the 1976 U.S. EPA Emissions Offset Interpretive Ruling, 41 FR 55524 (December 21, 1976).

19/ By the same token, the absence of a mechanism for saving excess emission reductions meant there was little incentive for sources to make more reductions than required.

The 1979 Bubble Policy allowed use of surplus emission reductions to meet new current or future requirements imposed by states on existing sources, while the 1979 revision to the Offset Ruling explicitly authorized storage or "banking" of surplus reductions to meet both existing and new-source requirements through such controlled trades. 20/

Once there is a recognized "right" to bank emission reductions created by a state banking rule approved by EPA, it seems likely that a government cannot take banked ERCs without satisfying the due process requirement of notice and some kind of opportunity to be heard. Assuming due process requirements have been met, the question is whether compensation must be paid to the owners of banked ERCs that are subject either to a moratorium on use, to discounting, to confiscation, or to increased use ratios.

Examples analogous to ERCs reinforce the idea that proper banking design can easily avoid this compensation ("taking") issue. Situations where the government has granted some economic (as opposed to social or welfare) entitlement or benefit include crop acreage allotments and broadcast licenses. In both of these situations, changes or adjustments are made so that some public benefit can be obtained. Crop allotments help maintain prices by avoiding oversupply of the crop and may need to be adjusted frequently (e.g., annually). Broadcast licenses are allocated (and adjusted) both to avoid signal interference and to provide the best community service. Adjustments to ERCs provide a similar public benefit by enabling a community to meet the goals of the Clean Air Act more economically without sacrificing public health concerns.

1. Crop Acreage Allotments.

Crop acreage allotments or quotas were first established under the Agriculture Adjustment Act of 1938. Each state is assigned an acreage allotment. The state and local governments apportion these acreage allotments to the counties and to individual farms within these counties. The purpose of the quota system is to prevent oversupply and a resulting drop in crop prices.

Certain criteria must be met in setting crop allotments. The determination of quota levels and assignments of allotments is not random or arbitrary. The Secretary of Agriculture is empowered to make an annual determination of the need for quotas and must announce any quotas in advance of the growing season.

20/ See 44 FR 71779 (Dec. 11, 1979) (Bubble Policy) and Revisions to EPA's offset policy, 44 FR 3274 (January 16, 1979) and 45 FR 52676 (August 7, 1980).

The Secretary's determination is based on market information and supply forecasts. Apportionment procedure is clearly defined in the Act. Generally, at the state and county level, historical growth data 21/ are used as a baseline and allotments are assigned proportionately.

There are several similarities between ERCs and acreage allotments. Both are intangible assets which are needed and used to do business in a specific area. 22/ Both can be bought and sold with transfers subject to strict conditions established by law, including geographical limitations. (Existing farmers have a first claim to allotments over new arrivals who must buy the rights to grow the crop either together with or apart from specific farmland.) Finally, allotments are adjusted periodically, as will be true for ERCs. The fact that federal crop allotment legislation specifically deals only with increasing the quotas, while adjustments to ERCs will generally be decreases required to satisfy Clean Air Act goals, seems a distinction without a difference, since both actions adversely affect the value of "rights" held by existing owners.

Courts have generally upheld the legality of crop allotments. The Supreme Court held that the initial establishment of crop allotments for tobacco (which placed limits on farmers' previously unfettered ability to sell all the crops they produced) was not an unconstitutional "taking" of property. 23/ Tobacco farms had begun preparation for planting before the law was enacted, but because of the law could not sell all of the tobacco harvested. The Supreme Court pointed out that the law did not take any of the tobacco, it merely limited what could be sold; if the farmers wanted, they could store their tobacco in excess of the quota and sell it the following year. This seems analogous to the situation that would exist if a state placed a moratorium on the use of ERCs.

21/ For example, the historical growth data for cotton is based on the average annual production of the crop over the preceding five years in each state.

22/ The IRS has ruled (Rev. Rul. 66-58) that sale of cotton allotments was the sale of an intangible capital asset within the meaning of Section 1221 of the Internal Revenue Code.

23/ Mulford v. Smith, 307 U.S. 38, 59 S. Ct. 41 (1939). Likewise, air pollution control regulations have been held not to operate as takings. See Sierra Club v. EPA, 540 F.2d 1114 (D.C. Cir. 1976); South Terminal Corp. v. EPA, 504 F.2d 646 (1st Cir. 1974).

In another situation the Court held that setting wheat acreage allotments was not improper. Although the allotments limited how much wheat could be planted on a particular farm, the limitation resulted in a market price that was much higher that the world price determined by ordinary supply and demand forces. 24/ In this circumstance, the Court refused to find either a taking or a denial of due process, since it was possible that wheat farmers experienced a net economic gain under the program. 25/ While the Court did not require that benefits exceed costs it is difficult, if not impossible, to show a deprivation of due process. Similarly, an ERC banking and trading program both confers a benefit (i.e., credit for emission reductions that previously would have been lost if not used immediately) and imposes a cost (the possibility that ERCs will be adjusted). The benefit (being able to avoid loss of all emission reductions not immediately used) clearly outweighs the cost (possible loss of some nominal portion of the saved ERCs). ERC banking and trading also confers other benefits (for example, substantial cost savings in meeting emission reduction requirements, increased value of discounted ERCs) which far outweigh the facial costs of adjustment, or even of confiscation. Both taking and due process arguments in the ERC context would probably be dismissed as they were for wheat allotments.

2. Broadcast Licenses.

Another area analogous to ERCs is that of radio and television station licenses granted by the Federal Communications Commission (FCC). The FCC may not only fail to renew a license; it may revoke a license for a number of reasons or simply eliminate a station to more fairly allocate licenses, wavelengths, hours of operation, or station power. 26/ The exercise of this authority does not constitute an unconstitutional taking of property without compensation. 27/ It seems precisely analogous to adjusting or reducing ERCs in order to accommodate changes in the SIP required to demonstrate attainment or maintain reasonable further progress with respect to National Ambient Air

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24/ The same type of reaction may be observed if "discounting" is used to adjust ERCs. Reduced supply may drive up prices, and indeed is likely to do so, making 90 tons per year of ERCs worth more than 100 held before the discounting.

25/ Wickard v. Filburn, 317 U.S. 111, 131, 63 S. Ct. 82, 92 (1942).

26/ Communications Act, 47 U.S.C.A. 307, 312. Federal and Radio Comm'n v. Nelson Bros. Bond and Mortgage Co.; 289 U.S. 266, 282, 53 S. Ct. 627, 635, 77 L.Ed. 1166 (1933).

27/ American Bond and Mortgage Co. v. United States 52 F.2d 318, 320 (7th Cir. 1931), cert. denied, 285 U.S. 538, 52 S. Ct. 311, 76 L.Ed. 931 (1932).

Quality Standards. The broadcast licensee will likely make a substantial investment in broadcasting equipment and facilities. If the license is revoked, the former licensee still has the equipment and facilities, but they are essentially worthless to that person because they cannot be used for their intended purpose. Thus, the revocation of a broadcasting license carries with it severe economic consequences. Nonetheless, the FCC is not required to compensate the former licensee for any economic loss attending the revocation of a license, even though taking away the license clearly deprives the former licensee of use of the broadcast equipment and facility. Of course, the equipment and facility may be sold, but at a much reduced price in relation to their market value if the license were still in effect. The same result follows if ERCs to be used for expansion purposes are taken: the expansion is not necessarily halted, but the additional facilities cannot be put to their intended use.

Like ERCs, broadcast licenses and crop allotments are not only conditional, but limited by required consistency with a major federal statute whose requirements are legally presumed to be known. The licensee is aware that the license may be revoked and on what grounds revocation may occur. EPA-approved state or local banking and trading programs will necessarily contain similar explicit conditions, and will be discussed more thoroughly in the final section of this paper.

The unique character of ERCs should be reemphasized. Unlike crop acreage allotments or broadcast licenses, ERCs are created under a health-related regulatory program. Courts have traditionally been less inclined to require compensation when property value decreases in response to health, safety or welfare considerations. Zoning is also an appropriate analogy; even ownership of land does not confer absolute rights. Acting within its police power authority, a municipality may control land use by zoning, and a property owner whose land value is adversely affected will not be compensated. The government cannot be made to pay for all its actions, even those with economic impacts on specified groups. That argument is even stronger where health rather than economics lies in the balance.

E. SUMMARY AND CONCLUSIONS

1. Review of the Taking Issue as Applied to ERCs

Four types of possible state or local government adjustments may be made to ERCs:

(1) an across-the-board percentage reduction in (discounting of) the amount (tons per year) of ERCs;

(2) an increase in the allowance ratio for using ERCs (e.g., two tons of banked reductions might be required to offset one ton of increased emissions);

(3) a moratorium preventing the owner from using its ERCs for a period of time; or

(4) a confiscation of ERCs.

- For purposes of this paper, it is assumed that ERCs are created for a specific purpose (use or sale), and that owners thus have expectations regarding the security of ERCs. (Where creation of ERCs is incidental to another primary action, e.g., shutting down a source or installing controls to meet basic requirements, a challenge to ERC adjustment is even less likely to succeed.)

The following points summarize the "taking" analysis under existing law:

- ERC adjustment necessarily promotes the health and welfare of the general public, since adjustment is triggered only to meet health goals (attainment and reasonable further progress towards attainment of air quality standards explicitly defined in Federal law); this is a valid regulatory purpose that has traditionally received great judicial deference.

- So long as ERCs are "taken" to promote health and welfare (including economic welfare, as by creation of a growth margin), and not to permit construction of a public facility, government action will be characterized as an exercise of the police power and not of eminent domain. Thus, according to the general rule, no compensation will be required.

- Courts will be highly unlikely to require compensation under a moratorium, which leaves much of the value of ERCs intact.

- A very substantial discounting or increase in the allowance ratio of ERCs would be sustained before compensation would be required, even in the absence of adequate prior notice regarding limitations on ERCs.

- ERC owners may have expectations, backed by investment, as to the security of banked ERCs. Where these expectations are clearly conditioned, prior to investment, by the rules and agency representations regarding a banking system's operations, no compensation would be required for subsequent adjustments to ERCs.

- Only complete and outright state confiscation of all banked ERCs raises even the possibility that a "taking" requiring compensation will be found. Even that possibility will be neutralized

if confiscation and the conditions which will trigger it, are explicitly set forth as an option reserved to the state in its duly promulgated banking rule. (This approach would, however, seriously deter private investment in ERCs.)

Because confiscation is legally permissible under the Clean Air Act but is so undesirable as a policy alternative, the "taking" problem is not real. States have several other options to effect necessary adjustments which will neither discourage banking of ERCs nor raise cognizable "taking" issues. Under these options (discounting, moratoria, or requiring increased amounts of ERCs for each use), there may not even be standing to complain, since the economic value of ERCs is not demonstrably impaired and their owners are not "aggrieved". Further, as noted earlier, states are free to refrain totally from adjustment, and obtain any needed reductions from existing sources.

Avoiding the Taking Issue

Several strategies for avoiding the "taking" problem are suggested below. The discussion is not exhaustive, but describes steps which should be generally effective in eliminating any potential "taking" problem regarding banked ERCs.

Advance Notice: If a prospective owner of ERCs is made actually or constructively aware, before ERCs are purchased or produced, that adjustments may later be necessary, it will be virtually impossible to claim persuasively that a "taking" has occurred when such adjustments are made. Since any decision to invest in ERCs will reasonably have included consideration of possible future adjustments, such adjustments cannot frustrate "investment-backed expectations".

Any banking and trading program should include measures to assure timely fair notice to prospective ERC owners of when and how adjustments to banked ERCs may occur. Specifically,

- ERC banking and trading programs should specifically include provisions dealing with possible future adjustments to ERCs. Adjustment should be treated in state and local banking and trading rules. Such rules should specifically state the purposes for which any adjustment would be made--e.g., to insure continuing compliance with the requirements of the Clean Air Act. Since EPA-approved banking rules must be SIP revisions requiring public notice and comment, potential ERC owners will have opportunity to comment on the possible ERC adjustments, and full notice that future adjustment is one of the conditions under which ERCs are granted.

- A banking and trading program should make an extra effort to inform potential ERC owners of the possibility of adjustments to banked ERCs. This can be done by requiring the face of every ERC certificate to include a specific and unambiguous notice that the quantity of banked ERCs might have to be adjusted downward to satisfy requirements of the Clean Air Act. The notice should specify how the adjustment will be made. In addition, all potential ERC owners should be given a copy of the banking and trading rule that includes assurances that fair procedures will be used in making adjustments.

- The banking and trading rule should specify procedures by which adjustments will be made as well as limits on the distributive effects of adjustments. For example, it may be wise to guarantee that adjustments to ERCs will be of no greater percentage than reductions required of existing sources.

THE IMPORTANT OF ADVANCE NOTICE IN AVOIDING "TAKING" PROBLEMS CANNOT BE OVERESTIMATED. Where entitlements are concerned, courts have indicated that the right bestowed can be narrowly defined by the state at the outset. What must be done in the banking and trading context is to specify what is granted granted when an ERC is awarded. Instead of an absolute right to full use of the face value of granted ERCs, the award should specifically reserve the right to adjust ERCs if it becomes necessary to do so.

Regulatory Means The means for accomplishing the adjustment, if deemed necessary, should be selected with care because some ERC adjustment methods seem less likely to cause "taking" problems than others. It is to a community's advantage to select those means which are least troublesome. Some factors to keep in mind when making this choice are:

- Avoid "taking" ERCs for use in some "entrepreneurial" fashion, such as providing ERCs for expansion of a municipally-owned power plant. Courts generally find a "taking" more easily when the government is acting as an entrepreneur than when it is acting to safeguard the health and welfare of its citizens.

- Avoid "confiscations." This adjustment method seems most likely to result in a judicial finding that a "taking" has occurred. It is also most likely to discourage participation in a banking and trading program.

- Apply the adjustment uniformly within classes. Courts generally are more inclined to accept as permissible a regulation of this kind if it is applied uniformly to those similarly situated.

The selection of the adjustment mechanism should be based on two criteria: (1) what best serves the needs of the banking and trading program, and (2) what gives ERC owners the greatest incentive to create ERCs while still satisfying requirements of the Clean Air Act. The suggestions below place only limited burdens on ERC owners, yet are practical means of effectuating a required SIP change.

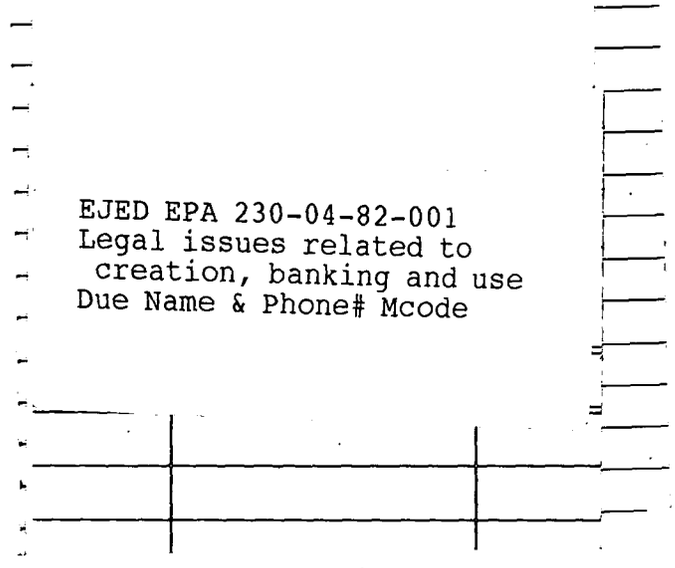
- Discounting (a pro rata reduction in the value of all banked ERCs). The methods of discounting ERCs should be specified in advance and should include notice that discounting may be necessary, what the triggering factors will be, and how the percentage reduction will be determined. Discounting would also increase the demand for ERCs, driving up their cost and making them more valuable per unit.

- Address future users instead of current holders of ERCs. The allowance ratio on use of ERCs could be changed so that an increase in emissions would have to be offset by more ERCs than previously required. For example, if a SIP change presented a situation where banked ERCs needed to be reduced by one-half, instead of requiring a 50 percent discounting of banked ERCs, the banking and trading program could double the amount of ERCs that must be applied to any emission increase. Whichever method is selected, the impact on cleaning up the air is the same.

- A partial use moratorium. The ERC owner would be permitted to use some percentage of its banked ERCs, but the remaining ERCs could not be used for the duration of the moratorium. No limit would be placed on the sale of ERCs. For example, if a firm owns 100 ERCs, a 75 percent moratorium would permit the firm to use (or sell) 25 ERCs. The remaining 75 ERCs could not be used but could be sold. The purchaser of the 75 ERCs, however, would buy them subject to the terms of the moratorium and could not use them until the moratorium expired. This approach combines the most attractive features of the moratorium and discounting options. The use of a moratorium enables the ERC owner to retain ownership of the full amount of ERCs; and the partial nature of the moratorium enables the ERC owner to both use and sell some portion of its ERCs.

G. AFTERWORD

The "taking" issue imposes no serious constraint on banking and trading of Emission Reduction Credits. It merely requires that the designers of banking and trading systems be sensitive to certain interests that should be protected. It is particularly crucial that prospective owners of ERCs be aware of precisely what interest they will be acquiring (whether by purchase or production) in an ERC. Governments are free to guarantee, in emissions trading rules, against ERC adjustment, and obtain any necessary further reductions from their inventory of existing sources. Where, however, a state or local government determines that it may be necessary to adjust the quantity of banked ERCs, that contingency and its consequences should have been spelled out to every potential ERC owner in advance. ERC ownership is not an unlimited right to use or sell the ERCs granted; ownership is contingent and subject to the rules established for the particular banking and trading system. One of those rules should deal directly and as explicitly as possible with the future adjustment issue.



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