Don't Skip The Air Emission Credits In M&A

Law360, New York (March 31, 2015, 10:36 AM ET) -- There is no shortage of environmental matters to navigate when buying a company or facility. Environmental counsel must first lead a diligence effort that delineates the target’s environmental footprint and then suss out the environmental risks and liabilities attendant to the deal. This diligence process often involves Phase I environmental site assessments, environmental, health and safety compliance evaluations, interviews of target personnel, and review of seller-provided permits, reports, and other documentation.

The knowledge gained from the diligence process feeds into negotiation of purchase agreement terms, including the purchase price, environmental representations, warranties and covenants, corresponding definitions and indemnification provisions, disclosure schedules, and permit transfer provisions. Myriad environmental matters must be addressed, including compliance with environmental laws, the release of hazardous substances, the presence and validity of environmental permits, ongoing environmental litigation or the possibility of it, and health and safety matters.

One issue that all too frequently gets lost in the shuffle during the diligence and purchase agreement negotiation process is the evaluation of whether air emission credits are necessary to run the business, and if so, how these credits will be treated in the deal documents. Air emission credits take many shapes and forms but, at bottom, are governmentally issued or approved authorizations to emit air contaminants. A wide variety of facilities — from power plants to petroleum refineries to manufacturers to hospitals — must often obtain air emission credits in order to lawfully operate. In recent years, air emission credit programs have even expanded to cover emissions beyond facility fence lines; certain
companies, such as transportation fuel suppliers, must now obtain air emission credits to cover emissions linked to the products the companies sell.

This article provides an overview of the air emission credit landscape from the perspective of acquirer’s counsel (although, many of the issues we raise herein must also be dealt with by sellers in M&A transactions, as well as by environmental counsel in financings and other matters). A first step in addressing air emission credits is to identify the applicable regulatory regime(s). In tandem, an evaluation is needed of the target’s operations and air emissions.

It is also essential to understand market conditions for air emission credits, potential changes to the regulatory regime, and a client’s business plans for facility operation. The structure of the transaction — whether the transaction is the stock purchase of an entire company, the asset purchase of a facility or a division, or a merger — also bears upon how air emission credits should be handled. All of these inputs should inform deal strategy and purchase agreement negotiation.

Programs Requiring Air Emission Credits

Air emission credits are required by many different programs, and a threshold consideration is identifying which programs are applicable. Emission credit requirements may be implemented by local, state, federal or foreign authorities. Some facilities, such as power plants, face numerous potentially applicable air emission credit programs. Some of the most common air emission credit programs are described below.

In the United States, one of the most frequently encountered air emission credit programs is the federal Clean Air Act’s (CAA) New Source Review (NSR) program. The CAA NSR program requires permits prior to the construction or modification of stationary sources of air emissions. “Nonattainment” NSR permits are required for new and modified major sources of air emissions in areas where air pollutant concentrations exceed the National Ambient Air Quality Standards (NAAQS) set by the U.S. Environmental Protection Agency for criteria pollutants: carbon monoxide, lead, nitrogen dioxide, ozone, particulate matter, or sulfur dioxide.

In order to obtain an NSR permit, a facility must purchase air emission credits to offset any increase in emissions. NSR air emission credits are created when a facility reduces emissions at an existing source (such as by installing more stringent control technology or shutting down operations). The idea is that, if an area is in nonattainment with the NAAQS, no facility will be allowed to increase its emissions unless the increased emissions will be counterbalanced by an emissions reduction at another facility. State and local regulators to whom CAA enforcement authority is delegated are left to flesh out the exact rules of the nonattainment NSR credit requirements, and these rules accordingly differ by jurisdiction.

There are also a number of cap-and-trade programs that regulate criteria pollutant emissions. Although these programs vary in their particulars, they largely feature the same components: (1) the requirements that any emitter of a regulated air pollutant both (a) measure its emissions and (b) obtain emission credits commensurate to its emissions; (2) a “cap” on the amount of marketwide credits in a given time period (which serves to limit marketwide emissions during that time period); and, (3) the ability to trade credits among regulated entities on an open market.

Cap-and-trade programs have found favor because they offer regulators the ability to set the caps at levels necessary to ensure given levels of emission reductions (and to dial the caps back over time to steadily reduce marketwide emissions) and because they offer emitters compliance flexibility. That is,
regulated entities have the option of either reducing their own emissions or buying credits from parties that are able to make more cost-effective emission reductions.

These criteria pollutant cap-and-trade programs include EPA’s “Acid Rain Program,” which went into effect in 1995 and targets emissions of precursors to acid rain — oxides of sulfur (SOx) and nitrogen (NOx) — from fossil fuel-fired power plants. EPA rolled out in 2015 a successor program, the Cross-State Air Pollution Rule, which requires power plants in 23 states to reduce emissions via a cap-and-trade mechanism. California’s South Coast Air Quality Management District (SCAQMD) instituted the Regional Clean Air Incentives Market (RECLAIM) in 1994 to reduce NOx and SOx emissions from facilities emitting over 4 tons per year of either pollutant, including refineries, power plants, aerospace manufacturing facilities, paper mills, chemical companies, food industry facilities, printers, airline facilities, asphalt plants, and many others. Texas’ Mass Emissions Cap and Trade Program applies to NOx emitters in the Houston-Galveston-Brazoria area, including oil and gas industry facilities, chemical companies, manufacturers, power plants, hospitals, universities and others.

New and emerging climate change laws make matters more complex, as companies now face requirements to obtain greenhouse gas (GHG) emission credits. In January 2013, California instituted an emission credit regime that caps aggregate annual emissions of GHGs from certain sectors of the economy. Covered sectors include the following: (1) electricity generators and importers; (2) producers of cement, glass, hydrogen, iron, steel, lime, and nitric acid; (3) petroleum refiners; (4) paper manufacturers; and, (5) stationary combustion sources. In 2015, suppliers of natural gas and transportation fuels were added to the program.

The Regional Greenhouse Gas Initiative (RGGI), an emission credit-based regime covering power sector GHG emissions, went into effect in 2009 in 10 northeastern and mid-Atlantic states (Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island and Vermont), although New Jersey withdrew in 2011. RGGI caps total power sector carbon dioxide (CO2) emissions and reduces them over time by requiring fossil fuel-fired electric power generators with a capacity of 25 megawatts or greater to obtain allowances in amounts equal to their respective CO2 emissions.

Abroad, the European Union Emissions Trading Scheme (EU ETS), which began in 2005, covers over 11,000 power generation and manufacturing facilities in 28 European Union and three other countries. Chinese provinces and cities, including Beijing, Chongqing, Guangdong, Hubei, Shanghai, Shenzhen and Tianjin, began implementing GHG cap-and-trade systems in 2013, and a national program is planned for next year. South Korea implemented a GHG cap-and-trade program in 2015. Similar programs are underway or under consideration in a number of other foreign jurisdictions.

**Due Diligence on a Target’s Air Emissions**

Once the applicable regulatory regime or regimes have been identified, a potential buyer must evaluate what the business it is acquiring must do in order to comply with the law. This task is complicated by the fact that sellers often have failed to comply with complex air emission rules and credit requirements. Sellers may not have been accurately monitoring or reporting air emissions. This may be a matter of not knowing what their air emissions have been (or, worse, intentional misrepresentation of those emissions to regulators). To the extent past emissions have not been accurately reported to regulators, a facility may not have the air emissions credits it needs to operate at present levels.

In fact, a facility may have been altogether left out of emissions credit programs (such as a cap-and-
trade program) if regulators failed to realize that the facility has emissions of a magnitude that require its inclusion. In many cap-and-trade programs, the early years of the program are when credits are freely allocated by the regulators to covered facilities. Being left out during these early years can mean missing out on an allocation of free credits.

Regulators are often loathe to disturb carefully calibrated emissions caps by giving out additional free credits years down the road, so skillful negotiation is called for in such a situation. If mishandled, underreported emissions problems can spell years of headaches and litigation, and in the worst-case scenario, large fines or a forced facility shutdown.

Determining whether emissions have been reported properly can require careful and context-specific diligence. Air emissions are not within the scope of a Phase I environmental site assessment, and unlike indicia of hazardous materials releases, they are not readily observable. Even a limited environmental compliance audit will usually fail to quantify a facility’s air emissions.

In order to identify air emissions, it may be necessary to have an environmental consultant knowledgeable as to the business’ processes and emissions profile conduct an in-depth review of the equipment that is present (which may be different than the equipment that is permitted) and how emissions from the equipment are monitored and quantified. Different jurisdictions have different rules as to how emissions need to be monitored and quantified.

For example, certain jurisdictions allow facilities to estimate emissions using emissions factors (such as by monitoring production and assuming that emissions from the facility are constant and can be determined using a conversion factor that translates production into emissions). In other cases, a facility must continuously monitor contaminant emissions and report those emissions to regulators in real time.

One helpful tool is the annual third-party auditing required by some programs, such as California’s GHG cap-and-trade program, to verify that facilities are accurately monitoring and reporting emissions. If available from the seller or the regulatory agency, such reports can be helpful in gauging the risk that a facility is inaccurately reporting emissions.

**Market Conditions, Regulatory Developments, and Business Plans**

In negotiating the purchase agreement for a facility or company, it may be protective to specify both what kind of and how many credits will be transferred. These issues, particularly the latter, often require an examination of the air emission credit market, actions the regulator may be taking to influence the market or otherwise modify the program, and a client’s business plans for the facility.

Emission credits come in different flavors and are often classified based on their duration and source of generation. Certain emission credits are only good for a specific compliance period, such as a calendar year or multiyear period. Others are good for indefinite periods.

Emission credits may also differ in how they were generated. For example, in cap-and-trade markets, compliance credits are normally created and distributed by the regulator running the market, while offsets are generated by entities voluntarily reducing their emissions. There can be wide price discrepancies between different types of credits, and the different types of credits may be subject to different regulatory requirements (such as invalidation requirements or holding limits).

Analyzing how many credits the buyer will need is more involved than asking how many the seller has to
provide. If a seller has been purchasing credits on an annual basis, the seller may not have any credits to provide to cover operations going forward. Even if a facility receives through the transaction enough air emission credits to permit future operation at the seller’s pre-transaction production levels, additional credits may be needed if a facility is to expand production or modify its operations.

If a buyer does not obtain through a transaction the air emission credits it requires to operate a business in the future at the production levels it would like, it could be expensive to obtain the credits — or even worse, there may not be any credits available.

In certain markets, credits may be held by a relatively small number of market participants who could be unwilling to sell credits to competitors. Or there may be far fewer emissions reductions available to generate credits than there is demand for such credits.

As one example of credit scarcity, the South Coast Air Quality Management District (SCAQMD) published in 2009 the following estimates of nonattainment NSR credit prices based on average market prices. Credits necessary to permit a printing press would cost $390,000. A spray booth at an auto body shop would require credits worth $500,000. Air emission credits for a boiler at a hospital would run $2,000,000, the same price as permitting a tortilla chip fryer and oven at a food manufacturing facility. A sewage treatment plant digester and flare would increase the cost to $3 million, and a new landfill would really up the ante, to $140 million. In order to determine how many credits would be needed, it is important to understand future production levels and credit market conditions.

Another important consideration is how regulators may modify emission credit rules over time. Regulators will often tinker with regulatory schemes to hasten the pace of emission reductions if necessary to meet regulatory goals, or to slow the pace of reductions if the economic cost of the program is too high. For example, regulators will sometimes shrink marketwide emission caps by reducing the value of each market participant’s holding, and buyers can protect themselves by understanding the program’s history regarding and rules governing such matters.

Closing the Deal

As to the purchase agreement itself, a key consideration is the extent to which the representations and warranties, any indemnities and other provisions will shift the risk of a failure to comply with air emission credit requirements. As one example, regulators may seek to invalidate seller-held credits following the closing — even if the seller did no wrong, which is a risk the purchase agreement could be crafted to address.

The overall structure of the transaction bears upon how risk can best be shifted. Representations and risk-shifting provisions differ among stock purchase agreements, asset purchase agreements and merger agreements. For example, in a public company-style merger agreement, there may be little ability to seek indemnification for breaches of representations and warranties, making presigning diligence all the more important.

With respect to the purchase of a single facility or a division via an asset purchase agreement, the buyer may have the ability to both (1) classify liabilities related to air emission credit noncompliance as “excluded liabilities” that the seller is stuck with and also (2) classify needed air emission credits as “transferred assets” to be conveyed as part of the deal.

If the primary risk-shifting mechanism is to be via environmental representations and warranties (and an
indemnity covering any breaches), as would be common in a stock purchase agreement, then it becomes important that the representations and warranties survive for a period of time sufficient for the buyer to confirm that it, its third-party auditor and the regulator are all satisfied that the representations and warranties are accurate.

The particulars of the applicable regulatory regime and its expected evolution, a buyer’s planned use of the facility, the relevant emissions market, the seller’s processes and emissions monitoring and reporting mechanisms, the type and quantity of credits available for conveyance, and the structure of the transaction all should inform purchase agreement negotiation and pricing. Air emission credits may often be overlooked in the transactional context, but careful attention to them is necessary if a buyer wants to be sure the value of its investment will not go up in smoke.

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