



CLEAN AIR
CONSERVANCY

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RGGI CO₂ BUDGET TRADING PROGRAM

SELECT COMMENTS ON DRAFT MODEL RULE

AS RELEASED MARCH 23, 2006

[Clean Air Conservancy letterhead]

Regional Greenhouse Gas Initiative (RGGI) Staff Working Group (SWG)

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May 22, 2006

**RE: Select comments on draft Model Rule
released March 23**

Dear Sir or Madam:

The Clean Air Conservancy (CAC), with its affiliated organization the Clean Air Conservancy Trust, appreciates this opportunity to comment on the draft Model Rule. We thank SWG for its path-breaking work and the chance to comment.

CAC supports the draft Rule and further RGGI development, consistent with these comments.

CAC has tracked RGGI developments from afar since shortly before the Memorandum of Understanding (MOU) was signed December 20. However, we only received Board approval to proceed with comments May 10. Thus these comments are select, provisional, and in some cases broad-brush. We have tried to focus on issues that appear critical not just to CAC, but to successful implementation of an environmentally-sound, cost-effective CO2 Budget Trading Program from the perspective of state agencies as well as affected sources, potential offset providers, renewable-electricity or similar producers, project financiers, ratepayers, and others. We have drawn on our environmental-finance expertise and more than 50 years' collective experience designing, implementing, participating in, and pursuing market-based approaches for accelerated, continuously self-improving emission reduction. We can support references in these comments to emissions trading or other precedents in more detail.

CAC is this country's first, oldest and largest¹ non-profit, non-partisan non-advocacy environmental organization formed primarily to acquire and retire emission reduction credits (ERCs) of all types for the public good. CAC leverages its resources to promote environmental education in grade schools, public awareness, and direct action by individuals, groups and companies.

CAC was founded as a 501(c)(3) in 1992 when the Acid Rain programs were just being implemented. It participated in the first CBOT auction of SO2 allowances, established a national network of elementary school children buying and retiring SO2 allowances to reduce their classes' environmental footprints, and soon was named one of the ten best small US environmental non-profits by Sierra Club's *Outside Magazine*.

¹ By ERC asset holdings.

Since then, CAC has served as a non-partisan resource to state agencies designing emissions-trading programs (e.g., for NO_x); facilitated numerous tax-deductible donations of ERCs by electric utilities or other emitters in locales ranging from the South Coast AQMD to Massachusetts; and pioneered “event greening.” In 2001-02 we helped make the Salt Lake City Winter Olympics “net zero” in emissions by quantifying, receiving and retiring sufficient volumes of SO₂, NO_x, and CO₂-e voluntary reductions to completely “offset” that event’s emissions of these substances.

CAC recently launched a national Net Zero Program to help make similar activities (such as weddings, rock concerts, sports events, individual or corporate transportation by vehicle or plane, company/branch offices, and eventually product lines) emissions-neutral. As always, CAC does not give preference to particular sources or categories of offsetting emission reductions, or seek to favor particular reduction-approaches or control technologies. Our policy has been that the market should determine what works.

We currently are exploring ways CAC could help backstop current ERC markets by ensuring “true permanent retirement” of the underlying environmental asset, above and beyond electronic certificates.

We also are exploring ways CAC could facilitate formation of a national secondary market for GHG reductions, thereby strengthening price signals with reduced incentives to hoard (not discover, make or disclose) likely additional reductions.²

CAC lives by ERC donations and acquisitions. In the GHG world, this means we must be mindful that RGGI’s outlines and many of its regulatory details will cascade through other states and regions, if RGGI is fully adopted and perceived to be successful. By the same token, perceived RGGI “failure” could bring those developments to a halt, possibly suspending or rolling back programs in the seven participating states.³ Perceived “failure” could choke the program at its start, due (for example) to lack of sufficient allowances for cost-effective compliance. Perceived “failure” could cast a shadow over federal legislative efforts. It could become a self-fulfilling prophecy.

Independently, eligibility for offset allowances under “final RGGI” will tend strongly to influence the price of surplus CO₂-e reductions across the country. That will affect such reductions’ value for non-RGGI transactions, and their “appraised value” for charitable contribution and retirement.

This generally will be true whether or not such “potential allowances” are traded into RGGI. It will be true starting as soon as 2008, when forward trades of allowance options or rights begin to

² More detail on CAC’s is available at www.cleanairconservancy.org.

³ One example is the regulatory and market turmoil arising from NJ’s 2002-04 suspension and revocation of its Open Market Trading Rules.

occur.⁴ And, while RGGI offset-allowance prices in the \$10+ range might benefit CAC in the short term, in the long run they will serve no one well.

Thus, CAC's immediate comment interests include helping assure, consistent with *pertinent* environmental integrity:

- (i) RGGI's perceived as well as actual "success";
- (ii) broader availability of offset and other allowances, as and to the extent they may be needed for compliance;
- (iii) allowance prices that do not reflect artificial scarcities created by geographical constraints, processing delays or other distortions;
- (iv) allowance-market "thickness" and liquidity, even at the price of some short-term theoretical "losses" under the cap;
- (v) minimal resource demands ("transactions costs") on *state agencies*, not just market participants, including initial or progressive elimination of case-by-case pre-approvals to the extent possible;
- (vi) greater regulatory and financing certainty for all Budget Source compliance activities, whether in-house or through "external offsets," and whether from new projects, project expansions or upgrades, or other existing-source actions;
- (vii) recognition of material state-by-state variations, by including in the final Rule a reasonable interstate adjustment mechanism or advance principles for such a mechanism. This would acknowledge that, especially as more states may elect to participate, likely state-by-state variations will not be *de minimis*; and
- (viii) cleanup or clarification of certain related provisions in the Rule.

We submit general points below, followed by specific comments. We make these in the spirit of CAC's guiding mission: 'to continuously improve our shared environment by retiring marketable ERCs in ways that can produce cleaner air, help slow the pace of global climate change, and improve the effectiveness and efficiency of existing and developing markets.'

A. General Points

1. RGGI is not "modest." By freezing regional CO₂ emissions from electric utilities over 25 MW faceplate capacity at ~ 1990 levels starting in 2009 and reducing those levels 10% between 2015-18, RGGI will require significant reductions from a sector that already is stringently

⁴ As forward trades have to our knowledge for every other emissions-trading program, whether cap-and-trade (e.g., Title IV Acid Rain, OTC NO_x Budget, EPA NO_x SIP Call/CAIR, EU ETS), "voluntary binding" (e.g., CCX), or rate-based (e.g., lead phase-down).

controlled in the NE, that already has shifted to low-emitting natural gas, regarding an emission for which few add-on controls appear available. Moreover, the available CO₂ allowances allocated to regulated Budget Sources could be reduced by *at least* 25% under the draft Rule for Consumer Benefit/Strategic Energy Purposes (CPSEPs), not counting other state set-asides for new CO₂ sources, renewable energy, and the like.

The participating states may be uniquely fortunate to the extent this 1990 baseline roughly equals currently-projected CO₂ cap emissions in 2009.⁵ Thus cap stabilization may not cause much initial pain.

However, it is not at all clear that currently-modeled 2009 emissions will match actual emissions, given projected electricity demand growth, planned fossil generating capacity, and other factors. If there is significant sector CO₂ growth by then, Budget Sources somehow would have to offset those additional emissions, above and beyond the reductions currently required or implied.⁶

We have concerns whether Budget Sources could comply directly under such a scenario through further fuel switching, source-unit shutdowns, or efficiency adjustments, consistent with reliability and ratepayer protection. This seems true even assuming that additional CO₂ reduction technologies not only are “forced,” but are sufficiently commercially-proven to support financing, by 2009. Given the 15-to-20-year planning/financing horizon for lower-emitting Budget Sources *and* potential allowance-offset projects, the effects could be severe.

2. Offsets will be important, not just for safety-valve cost Triggers but to some uncertain extent for basic compliance. They must not only be available in sufficient amounts, but be perceived to be readily available in those amounts under a range of likely scenarios, well before the regulatory program “kicks in.” We believe **the final Rule should expand offsets eligibility**, since the adverse program effects of potential over-supply appear much less severe than the effects of substantial under-supply. That seems particularly true over the longer run, for reasons below.

3. The dynamic nature of a cap-&-trade program should be better reflected in the Rule. Studies of Acid Rain and parallel programs have demonstrated that due to continuous reduction incentives, these programs tend to “squeeze out” (e.g.) “paper” reductions in relatively short order, with concomitant improvements in inventories and other implementation.⁷ Those studies also indicate that (a) any adverse program effects of somewhat relaxed allowance-criteria at the

⁵ We understand this is due in significant part to pre-2000 shifts to natural gas, but also that it may not be true for all participating or observer states. In addition, due to high natural gas prices and limited pipeline capacity, a significant portion of planned new NE generating capacity apparently is coal-based. This could “blow the cap,” especially if IGCC or similar technologies cannot be financed swiftly enough.

⁶ This growth effect could be much greater for the rest of the U.S., because national estimates imply that stabilizing CO₂ emissions at 1990 levels by 2008-12 would mean a 30+% reduction from 1990 levels.

⁷ In addition to reduced administrative burdens or costs. See, e.g., Ellerman et al., *Emissions Trading in the U.S: Experience, Lessons and Considerations for Greenhouse Gases* (Pew Center, 2003), pp. 18-20 passim (addressing both the general issue, unit substitution opt-ins, and industrial opt-ins).

threshold have been marginal for the pace and total volume of reductions, and (b) the overall regulatory benefits of ensuring more flexibility through offsets may significantly outweigh likely real-world effects on “cap integrity.”

4. Case-by-case reviews should be minimized. While early emissions-trading efforts by EPA and states laid the foundation for later cap-&-trade initiatives, the wrench in those works was the ongoing requirement to mesh trades with SIPs, either one-off by project-specific SIP revisions or through partial SIP “generic rules.”⁸ In either case (as with industrial opt-ins under the Acid Rain cap), case-by-case reviews, additional requirements meant to meet an impractical or marginal goal of making the program airtight, and resulting delays or burdens severely limited participation. That result tended to drive up compliance costs, in general with scant environmental benefit. It also posed significant resource drains on state agencies. It sacrificed steps that could have moved the SIP programs forward, with overall ambient gains.

The final Rule should not repeat those structural mistakes. For example, it **should not require detailed reviews for financial “additionality,” or detailed initial or repeat “consistency” reviews for prospective offset providers.** That seems particularly true for renewable-power sources such as, for example, landfill-gas-to-electricity (LFGTE) projects, which already must generate, maintain, and certify multiple output reports, including reports to the Internal Revenue Service or state counterparts where federal or state tax credits or similar benefits are involved. It may be true for certain other “pre-approved” categories of potential offset providers.

If such requirements remain in the Rule, they should be implemented by general criteria and postcard notice, including warranties by applicants that pertinent criteria will be met. Where detailed case-by-case review may not be avoidable (e.g., for non-category offsets applicants), the first application approved by any participating state should be the legally-presumptive template for applications in other participating states.

5. “Regulatory certainty” is paramount. Regulatory certainty also means planning and financing certainty.⁹ For example, without predictable permits, planned projects will not get term sheets. Without sufficiently predictable positive revenue streams over the life of the project (read, net present value of after-tax net revenues for at least 15 years), projects either will not be built, or may be built subject to onerous finance terms that discount supplemental revenue streams (read, credit enhancement),¹⁰ towards zero.

⁸ E.g., n. 7 above. See also, e.g., Levin, “Building a Better Bubble at EPA,” *Regulation Magazine* (AEI, March/April 1985), pp. 33-42; US EPA, “General Principles for Creating, Banking and Use of Emission Reduction Credits” (Final Emissions Trading Policy Statement and accompanying Technical Guidance) (ETPS), 51 FR 43814-43860 (Dec. 4, 1986).

⁹ “Certainty” often is misused in this context. In general, no project requires absolute certainty to be financed and move forward. However, with rare exceptions, every project must demonstrate what risks it involves and how those risks will be bounded, allocated and addressed, in an input-output manner sufficient to quantify risks and assess probabilities or trade-offs. Inability to provide and substantiate such data on any key component (including “new-technology” risk, which typically includes non-commercially-demonstrated configurations of proven process elements), generally means the project will not get built, or will be built only with higher interest, greater debt-coverage ratios, and greater reserve requirements that may threaten its long-term viability.

¹⁰ Such as (but not limited to) revenues from RECs or tax credits.

Detailed project-specific reviews with uncertain criteria and timeframes, like repeat reviews on cycles shorter than life-of-the-project, undercut minimal certainty. They create barriers to market entry, with the adverse consequences such barriers imply.

6. Mid-course correction should be the over-riding safety valve. On-the-ground effects and performance of RGGI six years from now cannot be predicted, let alone guaranteed. Other cap-&-trade programs have contained built-in, largely automatic mid-course corrections ---such as the Acid Rain “ratchet” --- to protect their cap results.

These approaches tend to have minimal effects on regulatory/financial certainty. This is in part because (a) whether they may be triggered can be readily tracked by agencies and market participants, and (b) they provide comfort that individual sources or source categories will be not be singled out to correct any shortfall. Instead, any pain generally will be distributed equally by shrinking the overall cap.

The Acid Rain program fundamentally relied on its Phase 2 and ratchet mechanisms to assure emission-reduction results, recognizing that numerous classes and significant volumes of additional “extra-cap” SO₂ allowances were distributed or authorized, and expected to be used, in the program’s early years. It also relied on these mechanisms to enforce compliance discipline over time. That model --- initial “liberality,” followed by a phase-down to squeeze out excess or inappropriate allowances, backed by an automatic crank-down if projected results were not materially achieved --- parallels the situation SWG faces now.

The draft Rule already provides for a general mid-course review in 2012, after the first 3 year compliance period. To allow greater initial flexibility, minimize the burdens of that review, and protect the cap’s long-term integrity, **this provision should be supplemented by an automatic ratchet mechanism¹¹ contained in the final Rule. Participating states should be required to commit to implement that ratchet, if triggered.**

CAC believes this would more than compensate for any short-term reduction or cap uncertainties that might arise from adopting our other recommendations. We note that RGGI is formally the “CO₂ Budget and Trading Program.” The draft Rule, like the MoU and surrounding documents, recognize the centrality of emissions trades by consistently giving them equal billing with mandated CO₂ reductions. If active trades do not occur swiftly and in sufficient volume, before 2009 by forward contract and/or through RGGI trade-mechanisms afterwards, the mid-course correction point will not be reached. That could be a worse result than assuring robust initial trading activity, even at the expense of some possible “foregone” reductions.

¹¹ Subject to further comment.

Most other trading programs have expressly or tacitly accepted such short-term risks, judging full, free opportunities to trade for compliance to be more important.¹² CAC sees no reason for SWG to depart from that approach.

7. RGGI should be set up to “succeed,” not “fail.” This point encapsulates our preceding ones: Robust trading is critical to initial perceptions of “success.”

In particular, if sufficient offsets are not available *and seen to be available* from the get-go, RGGI could “fail.”

In particular, **any approach that pits an emergent RGGI offsets market against an established more-predictable RECs market, likely will end with RGGI the loser.**

For example, **Attachment A** compares \$5/mton CO₂-e prices --- CCX’s historic high to date --- with contemporaneous prices for TRC and compliance RECs reported by Evolution Markets for March 2006.¹³ As indicated, ***RECs prices wipe out CO₂-e prices in almost every case, usually by substantial margins. Moreover, the comparison suggests, CO₂-e prices would have to approximate \$10/ton --- the draft Rule’s ultimate safety-valve trigger ---- just to achieve parity with current RECs prices.*** Even assuming substantial increases in RGGI allowance prices post-adoption over these CCX indicators, this comparison appears to be quite conservative.¹⁴

We see little reason why any renewable-power generator would choose to give up RECs to become eligible just to apply (but still perhaps not qualify) for RGGI offset allowances that will be less bankable for initial financing or project-viability purposes. Thus, RGGI offset allowances could well be in very short supply, and planned safety valves may largely be empty boxes, if the draft Rule proceeds unchanged.¹⁵

This raises “financial additionality,” CAC’s first issue-specific comment below.¹⁶

¹² Even in an air toxics context, the MACT early reductions program (ERP) not only minimized statutory limits on trading flexibility, but expressly justified its less-than-MACT baselines by pointing to the health benefits of early reductions and to equal or greater long-term results.

¹³ Conversion factors used for Attachment A are DoE/EIA’s average regional- or state-specific emission factors for CO₂/KwH, based on the area’s reported mix of fossil fuels for all-in generation (utility and NUG) 1998-2000. EIA and the 1605(b) program characterize these as “reasonably accurate default values.”

¹⁴ E.g., RECs prices also seem likely to rise due to adoption of RPS by more neighboring states, and adoption of more stringent RPS by states (like NJ) that already have an RPS. In addition, CAC has reason to believe that spot prices reported by Evolution Markets are relatively low compared to the entire Northeast/Mid-Atlantic RECs market, because spot prices do not capture the higher value of structured sales of longer-term streams of RECs.

¹⁵ This also could be true for legal reasons independent of price factors, if “offsets” from NAFTA countries or the EU were held to be inadmissible on federal pre-emption, international treaty, or other constitutional grounds. That concern appears non-trivial, though so far as we know SWG has no current plans to address it.

¹⁶ We incorporate by reference in Part B the bolded specific issue comments or recommendations that appear in Part A above. Issues in Part B are in addition to those comments or recommendations.

B. Issue-specific comments

1. “Financial additionality” criteria for offset allowances should be removed from the Rule. We support the MoU’s basic criteria that offset allowances must be “real, surplus, verifiable, permanent, and enforceable.” In general, these are the traditional tests for creditable surplus reductions in emissions trading schemes.¹⁷ They also are the general tests for “environmental additionality” under the Kyoto Protocol and the EU ETS.

However, CAC has serious questions whether any “financial additionality” (FA) criteria --- including but not limited to those proposed in the draft Rule or suggested for comment in its *de facto* preamble¹⁸ --- are appropriate or workable for a final Model Rule.

Fundamentally, as the preamble recognizes, FA is an inquiry into subjective business intent: whether a project would not go forward (or otherwise-creditable CO₂-e reductions be produced), absent receipt of marketable allowances. This essentially requires that *only projects which are so economically-marginal (financially-shaky) that they likely would not proceed but-for a grant of allowances may qualify as offset providers*. The concept is inimical to core principles of the Budget Trading Program. Authorizing offset allowances only for reductions generated by projects on the verge of “being in the red” threatens the permanence and vigor of any trading market, since the project could fail and associated allowances could disappear at any time. It also runs counter to the need for regulatory certainty and financing predictability noted above.

Budget sources likely will think twice before accepting such allowances for multi-year compliance purposes. If they should purchase such allowances, they likely will undertake further financial diligence and/or discount them substantially for additional risk, because offset providers meeting proposed FA tests typically will not be creditworthy enough to provide meaningful warranties. Such outcomes would defeat the underlying purposes of encouraging such projects (by reducing offset revenues) while increasing the opportunities for more certain, cost-effective and rapid compliance by Budget Sources. The transactions costs for Budget Sources could forestall many such trades.

EPA long ago concluded that subjective-intent inquiries are a blind alley that eats up agency resources (often with little air benefit), diverts scarce program resources into financial reviews

¹⁷ We note, however, that the quoted phrase consists of terms-of-art, established over two decades, that have acquired specific meanings in regulatory contexts. Those meanings often differ from common usage. For example, “real” customarily has been equated to “surplus” for regulatory compliance purposes. See text at ____ below. Similarly, “permanent” customarily has been interpreted to mean “permanent for the period during which the resulting ERC is used.” See generally, ETPS, 51 FR at _____passim.

In light of these settled meanings, CAC also questions certain narrow aspects of the draft Rule’s “environmental additionality” tests. See B.7 below.

¹⁸ “States Solicit Comments on Draft Model Rule” (March 23, 2006).

that regulators are ill-equipped to pursue, and derails the speedy predictable approvals needed for potential reduction-providers to participate.

Instead EPA chose a different course. It recognized that “project go” and “project continue” decisions, like “unit shutdown” and innumerable other business determinations, result from multiple company- and site-specific tipping factors that never can be isolated with any confidence. It concluded that a simple objective test for “surplus” --- whether the proffered reductions *currently and clearly are required to be made by pertinent regulatory mandates*¹⁹ --- was the only workable way to proceed. It declared any reduction beyond this straightforward marker to be “surplus,” despite its acknowledgements that (a) some *non-determinable* quantity of “paper” reductions might be credited in the short run, and (b) trades for compliance would occur where total required reductions, or ability to achieve them, might be in doubt. It relied on the ERC and financial markets to deal with subjective intent, and on RFP, SIP calls, and similar mechanisms to address total required reductions.²⁰

To our knowledge, EPA and the states generally have adhered to that course ever since. Adding FA as a “surplus” requirement would invite agency micro-management and indeterminable delay of potential trades. It would risk replicating the problematic CMD Board approval process, as demonstrated by SWF’s current descriptions of how FA options and the process for approving offset allowances (e.g., for qualifying “market penetration”) might work.²¹ It would undercut the Program’s explicit intent to encourage more renewable-generating projects, by selectively discriminating against some --- but not all --- offset projects that receive other incentive-type benefits. It would do this notwithstanding the RGGI program’s goal of complementing such parallel programs.

The draft Rule, like the overall Budget Trading Program, rests on offset allowances being not only sufficiently available, but indistinguishable from any internal allowances that may be freed up under the cap. It does not apply any FA criteria to under-cap allowances used for compliance, although similar FA concerns well may apply to many such reductions. Instead, consistent with precedent, it relies on the cap and 10% phase-down to manage such uncertainties. Because a final Rule cannot afford the potential results outlined above, it should follow those precedents here.

We strongly recommend that in lieu of FA tests, offset allowances should be treated the same up-front as freed-up allowances under the cap. Prospective offset-allowance

¹⁹ Including a prospective “generic RACT” baseline generally equal to an 80% reduction, for VOC source categories providing ERCs in non-attainment areas lacking complete approved attainment demonstrations.

²⁰ See generally, EPTS at _____.

²¹ These passages also suggest that there is no meaningful way to “standardize” FA criteria, consistent with approval predictability. Either additional information for “completeness” often will be required, or participating states will be driven to accept applicant submittals more or less at face value, in effect rewarding more sophisticated players and undercutting the thrust of FA. That recalls the old bad SIP days before EPA’s final Bubble Policy, when emissions trades were withheld as a last-ditch carrot to induce settlement agreements from recalcitrant non-compliers, and good actors were penalized thereby. Such implementation issues should be brought into the sunlight and addressed by up-front program modifications, not left to be dealt with sub rosa.

providers should at minimum be allowed to elect an alternative streamlined opt-in procedure (or reasonable equivalent) that would bring their CO₂-e emissions under the cap. This would in effect make such total inventory emissions enforceable, which is what a cap seeks to achieve. Any uncertainties then would be automatically addressed by general cap-management, without the need for detailed FA demonstrations or pre-approval review.

If such an approach cannot be developed in sufficient detail in time for inclusion in the final Rule, we recommend that all FA criteria be removed from the Rule and reserved pending such development, and re-assessed when that development is complete.

2. “Business-as-usual” (BAU) and related issues. No different result seems required by underlying concerns that offset allowances approved without an FA review might in some sense be “non-surplus,” be “double-counted,” or “have occurred anyway.”

First, if the Budget baseline is 1990 CO₂ emissions, all reductions made after that baseline period analytically should count against future stabilization and reduction requirements. EPA and states have long recognized this principle, in PSD increment as well as formal emissions trading contexts.

Second, as EPA and states also have recognized, whether a reduction “might have happened anyway” is not the correct test, and even if it were, determining “anyway reductions” is subject to significant practicality constraints. Unless and until an allowance-generating source surrenders its permit or takes some other enforceable action to terminate or modify an emissions-related activity, whether associated reductions will be made or continue is a day-to-day business decision, subject to product demand, market projections, internal capital costs, internal hurdle rates, unit or source returns, and many other factors (potentially including PUC or RTO review). Applying a yardstick other than whether such reductions currently-are-required seems a fruitless and counterproductive exercise. In all other circumstances they should remain “voluntary” for allowance-crediting purposes. Because nothing requires them to continue, that is what they are.

Third, flatly discrediting offset allowances from projects that receive system-benefit or CBSEP funds, or RECs or other incentive benefits --- thereby requiring such projects not only to “pick a market,” but to “pick an incentive” on a binary, mutually-exclusive basis --- seems anomalous, analytically flawed, and unwise.

The Clean Air Act itself implies that reductions made “incidental” to mandates under a specific program may be credited for compliance with other mandates under that program, *and* that non-incidental reductions made to comply with one program also may be credited “cross-Title” for compliance with mandates under other CAA titles.²² EPA consistently has credited such “parallel reductions” under both programs --- for example, allowing credit for Title III MACT reductions in ozone precursors against Title I ambient-attainment requirements --- recognizing that no pertinent double-counting occurs because those reductions are “used” for different

²² See, e.g., CAA Sec. 173(c)(2); Guidance, S. Rothblatt (EPA R. V) to T. Method (March 29, 1994).

purposes and the goals of both programs are served.²³ Whether or not technically “voluntary,” such reductions often have been “dual credited” to advance the overall programs, relying on downstream backstop mechanisms as safeguards. Especially if (but regardless of whether) offset allowances are expressly brought under the cap, there should be no pertinent double-counting of CO₂-e reductions generated by such projects here.

Moreover, the specific FA criteria in Sec. 10.3(d) of the draft Rule appear both arbitrary and dangerous.

For example, there is no apparent reason why renewable-generating projects that are stronger (more financially viable) because some part of them received system benefit funds, should be disqualified, when the purpose of both programs is to encourage such projects and RGGI depends on the continued existence of such projects.

For example, there is no apparent reason why only projects that receive the specifically-listed incentives should be disqualified, but not those that receive federal or state tax credits --- or loan guarantees, REPI payments, sales tax rebates, and numerous other incentives --- when all such projects equally reduce CO₂-e and may be equally posited to have “happened anyway.” Such distinctions raise due-process rational-nexus issues that, if crystallized in a court challenge, could halt the Budget Trading Program. The draft Rule creates a slippery slope that puts at risk allowances from all such projects.

For example, there is no apparent reason why the draft Rule should require offset providers to surrender not merely their rights to CO₂-e attributes, but to “any and all attribute credits generated from the operation of the project.” That language facially would include Acid Rain SO₂/NO_x reductions, CAIR allowances, emergent White Tags for conservation efficiencies, water trading credits, and a range of other environmental “attributes,” above and beyond CO₂-e. It would needlessly penalize offset providers, create an unjustified windfall for state RGGI agencies, and disrupt other established programs or promising emergent initiatives.

Most specifically, assuring reasonable CO₂ cap integrity should not require that offset-allowance providers surrender their rights to RECs. Contrary to the draft Rule’s apparent assumption, CO₂-e does not constitute most (or in some cases, any) of the value of RECs. Nor is there a necessary connection between the “attributes” embodied in particular RECs and any CO₂-e reductions which may be associated with those RECs.

RECs generally are defined by state-specific RPS programs. Those programs’ definitions of valid “compliance RECs” vary significantly. They include power generated from municipal

²³ See, e.g., Final Title IV NO_x Rule, 59 FR 13538, 13557 (March 22, 1994); EIP Rules, 59 FR ___, at 16691 (___, 1994) (limiting “double-counting” to double-counting *for SIP purposes*); Hon/RACT Interface Draft Guidance, 58 FR 54136, 54138-39 (Oct. 20, 1993); Final ERP Rule, 57 FR 61970, 61987-89 (Dec. 29, 1992); ETPS, 51 FR at 43824-25, 43841 col. 1, 43845-46. See also, e.g., IL EPA, *[Cap- &-Trade] Design for VOM Emissions Trading System* (March 1995), pp. 45-46 (expressly allowing MACT sources full Title I credit towards RACT or RACT-plus reduction mandates, for otherwise-valid volatile organic reductions, in part to avoid trading complications and “penalizing [MACT sources] from the ozone attainment perspective”). For a recent example, see the final MACT PPP Coating Rule, ___FR ___ (___, 2004).

waste combustors, coal gob combustors, and other sources whose CO₂ emissions may be greater than those of most renewable (non-fossil) generation. They grant RECs for generation (e.g., wind, solar, small or other hydro) whose sole greenhouse contribution is indirect, difficult-to-quantify displacement of fossil-fired generation, not direct CO₂-e reductions.²⁴ Their dominant purpose has been to encourage energy diversity, distributed generation, local self-reliance, and similar goals --- aims that have scant proportional relationship to CO₂-e reductions.

RPS programs also tend to allow some flexibility for market participants to define by contract what constitutes a REC. Numerous transactions that split RECs sales from CO₂-e placements have occurred in the last few years, with more in the pipeline.

CAC is concerned that a seminal regulatory regime which flatly bars RECs for CO₂ reduction purposes could erase the line between RECs and CO₂-e, and could disrupt these markets. SWG should not promote such results or give further encouragement to some who currently seek to market RECs and CO₂-e credits as interchangeable. The dual-credit precedents above suggest a better path.

CAC strongly recommends that offset-allowance providers be authorized to benefit from RECs without restriction, and that SWG not set up a potential collision between RECs markets and emergent CO₂-allowance markets. In addition, the final Rule should clearly state that any REC-related restrictions it may retain, are adopted for other reasons.

3. “Baselines” for early Budget reductions and allowance-offsets. The draft Rule would create special “late term” baselines before which neither type of allowance could be generated.²⁵ It also would preclude allowances unless *the project* generating such allowances commenced operation after these dates.

Neither baseline constraint seems consistent with a 1990 baseline for the general Budget Trading Program. Both would bar otherwise-valid reductions from qualifying, although the air (in this case, the global atmosphere) does not distinguish between reductions from projects commenced (say) pre-2005 and those commenced afterwards. In both cases, nothing requires pre-baseline projects to keep operating, and some of them may operate longer if they can sell CO₂ allowances. In both cases, “true early voluntary” CO₂-e reducers --- including those who took actions starting in the mid-1990s in response to Clinton-era Climate Challenge programs or state

²⁴ We note that the draft Rule apparently would not allow offset-allowances from wind or any other non-emitting “displacement” generation. This omission seems odd given RGGI’s goals and the portion of renewable generation expected to be produced by such sources over the next 10 years. It suggests that potential allowance shortfalls may be greater than expected with exclusive reliance on offset sources that the draft Rule authorizes or conditionally-authorizes --- i.e., landfill methane capture/destruction, SF₆ reductions, carbon sequestration due solely to afforestation, reduced CO₂ emissions due solely to end-use HVAC efficiency in commercial or residential buildings, methane reduction by better agricultural manure management, and methane reduction from improved natural gas transmission/distribution. It also would penalize direct-reducers (such as LFGTE projects) by requiring them to surrender RECs, when many of their renewables competitors would not have to do so.

²⁵ Generally, not before Dec. 20, 2005 (the date of the RGGI MoU) for offset providers, and not before 2005-08 for “early action” Budget Source reducers.

counterparts --- would be penalized by these special baselines. SWG should not make the perfect the enemy of the good, by fostering such results.

We strongly recommend that any project which commenced operation after 1990 be eligible for offset-allowances, if it otherwise qualifies under the Rule's final "environmental additionality" tests.

4. "Maximum percentage" of compliance by offset allowances. The draft Rule would limit Budget Source compliance to no more than 3.3% of a Source's reported CO₂ emissions, absent special trigger circumstances that may be difficult for Budget Sources or offset providers to respond to sufficiently in advance.²⁶ We understand that because this percentage is of total reported CO₂ emissions, not required reductions, it could amount to as much as half of some Budget Sources' compliance requirements.

However, that estimate rests on modeled projects that involve considerable uncertainty. We also understand its derivation is general and on-average, meaning that some Budget Sources may face substantially greater on-site or in-system CO₂ reduction obligations.

Any limit on covered sources' ability to comply *with maximum flexibility* through external offsets contravenes the basic premise of a market-based cap-&-trade approach. It also smacks of control-for-control's sake that should have no place in such an approach.

In most of the analogous programs, the "market" --- prices for under-cap or external allowances, versus each covered source's (externally unknowable) costs of reducing pertinent emissions to the point where allowances are cheaper than further internal reductions --- automatically drives compliance decisions, without agency intervention. That is, under cap-&-trade the market sets a clearing price for reductions and allowances, rather than (as with a carbon tax) fixing a price and letting the market clear corresponding emission amounts. This is perhaps the most fundamental aspect of emissions trading. It is emissions trading's primary justification in terms of reduced agency burdens, easier enforcement, continuous incentives for sources to find and disclose additional reductions, substantially reduced compliance costs, ease of downstream adjustment for environmental integrity, and so forth.

We strongly recommend that percentage limits on Budget Source compliance by offset allowances be removed from the final Rule, or in the alternative be adjusted upward substantially.

5. Industrial process upgrades should be eligible for offset allowances. So far as we have been able to determine, neither the draft Rule nor SWG have addressed this source category. CO₂ emissions from refineries, central gasoline distribution, cement plants, paper mills, electric-arc steel production, and many other sources generally are substantial throughout the U.S.

²⁶ In our experience, the lead time for any significant renewable-energy project to come on-line generally has been at least 3 years, and involves (among other things) soft-cost design efforts, advance permitting, negotiation of preliminary input-output contracts, negotiation of preliminary financing based on those contracts, definitive documentation, disbursement of construction financing (including meeting numerous conditions to such disbursement), one or more years of construction, and various shakedown phases.

While they may represent smaller proportions of CO₂ emissions in the seven current participating states, that plainly is not true for observer or semi-observer states such as Pennsylvania and Maryland, or inventories in other states that soon may adopt so-called “RGGI clones.”

Process-automation upgrades (including in some cases planned switches to renewables-recycling such as increased combustion of black liquor for paper-mill process heat) recently have become big business in these sectors. Many such upgrades may reduce CO₂-e. They offer the prospect of easier quantification/verification than some of the draft Rule’s listed categories of potential offset-allowance providers.

We recommend that efficiency gains from process upgrades involving directly reduced CO₂-e emissions from industrial facilities, as well as indirect CO₂ reductions from better end-stage fossil fuel use for office or residential buildings, be authorized or reserved conceptually in a final Rule.

6. Donations of allowances as a result of litigation settlements. Under some of the draft Rule’s “environmental additionality” language, allowances confirmed by settlement agreements and later donated to support a SEP or nonprofit environmental organization, could lose their validity. Such donated allowances comprise a substantial part of CAC’s current asset holdings, and are expected to grow in the future. The same is true of certain other environmental organizations, such as the Environmental Resources Trust (ERT) and perhaps the Oregon Climate Trust.

RGGI’s CO₂ Budget Trading Program should not cut off or compromise such environmentally-beneficial activities, either directly or as a template. As with permit modifications confirming the enforceability of CO₂-e reductions offered by offset-allowance providers, the “requirement” component of judicial or administrative settlements is ancillary to a primary, voluntary decision to effect such a settlement.

We strongly recommend that the draft Rule be modified to make clear that Budget Program allowances (whether internal or by offset) contributed to environmental organizations pursuant to settlements or similar actions, do not lose their validity in any respect because they might then be deemed “required.”

7. “Environmental additionality” for LFG projects. The draft Rule states that offset allowances “shall not be awarded to a project . . . that is required pursuant to any local, state or federal law, regulation, or administrative or judicial order.” It goes on to state that projects which have been awarded allowances (in the draft, through consistency determinations) “shall not be eligible for . . . allowances after the effective date” of any such action. For landfill methane projects, it adds that “eligible projects” are solely those “at landfills that are not *subject to* [EPA’s] New Source Performance Standards (NSPS)” for LFG emissions control.²⁷

²⁷ Secs. 10.3(d)(1), p. 92; 10.5(a)(1), p. 99 (emphasis added).

As noted elsewhere, subject to these comments CAC strongly supports the general (indeed, exclusive) use of the draft Rule's "environmental additionality" criteria for eligible offset allowances. *However*, these provisions appear to raise three issues that should be addressed in a final Rule. While CAC does not give preference to any particular type or method of generating otherwise-valid reductions, and two of these issues relate to LFG offset providers, we deal with all three due to our general market-strength concerns.²⁸

First, the "local, state or federal" rubric could preclude landfill offset allowances across-the-board. Virtually every MSW landfill in the U.S. capable of generating material amounts of CH₄ is required affirmatively to comply with local solid waste mandates for *limited* LFG control for migration, odor and explosion-mitigation purposes. Virtually every significant MSW landfill in the U.S. that did not close by the early 1990s is required affirmatively to comply with similar *limited* LFG control for those purposes, under EPA's Sub-D solid waste rules.²⁹

However, the key here is "limited." Where triggered and not defeated by post-closure determinations, these measures typically are met by isolated "candlestick" flares that act passively and destroy relatively small amounts of LFG, without a comprehensive collection system under negative pressure or any productive use of "collected" gas. In addition, these measures arise under a different environmental program, and were imposed for very different purposes. For these reasons, consistent with the "dual credit" precedents above, even CCX --- which generally adopted the most stringent feasible rules to facilitate its "voluntary binding" experiment in carbon trades --- has looked only to the LFG NSPS/EG to define what LFG reductions are "surplus." The MSW and LFGTE industries generally have done likewise. The draft's current language could needlessly disrupt those practices, and could make the Rule's first category of eligible providers a null set.

Second, in the NSPS context, we believe "subject to" is over-broad for purposes of defining voluntary surplus reductions. A landfill that meets threshold closure-date and size criteria may be "subject to" the LFG NSPS/EG in many different ways, ranging from postcard notice and minimal emissions tracking, through full mandatory compliance under an agency-approved Compliance Plan. In general, even submittal of a Compliance Plan triggered by modeled NMOC emissions over 59 TPY (the NSPS/EG control threshold) does not impose specific practicably-enforceable control requirements, until that Plan is reviewed and approved (typically, through incorporation in the landfill's Title V permit). Affirmative LFG control before that point generally remains non-required, so far as the NSPS/EG are concerned.

The Congress recently recognized this fact by amending the Internal Revenue Code to provide that Section 29 tax credits are reduced (because LFG collection "might have happened anyway") only for landfills that are "required to control" under the NSPS, not merely those that are "subject to" the NSPS. The final Rule should do likewise.

²⁸ We also note that SWG appears to treat LFG reductions as its first-priority target for potential offset allowances, not merely the first project category on the draft Rule's list.

²⁹ 40 CFR Part 258, Subpart D.

Finally, we believe the intent of draft Rule Sec. 10.3(d)(1) is to ensure at least 10-year predictability vis-a-vis offset purchasers, where offset allowances have been granted but those reductions subsequently become “required” by pertinent order or rule. Unfortunately, the text could be read to mean that such allowances *become ineligible on the effective date* of such changes in law, a result that could wipe out offset predictability. This section should make clear that no such results are intended.

CAC recommends that the final Rule clarify the pertinent provisions as suggested above, either by modifications to Sections 10.3(d)(1) and 10.5(a)(1), or a special superseding provision for landfill projects in Sec. 10.5 (a).

8. Standards for allowance “retirement.” CAC permanently retires allowances or other ERCs by transferring any and all title and rights to them *and the underlying reductions* to its Conservancy Trust, whose 501(c)(3) charter specifies that such restricted assets can never again be transferred out in whole or part, directly or indirectly, for any purpose. CAC requires legally-binding documentation to assure this result.

We understand that the Budget Trading Program, like CCX and (in certain respects) the Acid Rain Allowance Trading Program, plans generally to rely on cancellation of serially-numbered electronic certificates to ensure appropriate “retirement.”

At the same time, other markets in TRCs (so-called “voluntary RECs”) and carbon-related derivatives have been to emerge and be promoted. Some of those promoters claim that RECs may be used fungibly with ---or even as --- carbon offsets, and some businesses that have purchased these poorly-defined products claim their CO₂-e emissions now are fully offset. Some of these entities claim that they are “retiring” carbon offsets by unspecified means.

Moreover, in most of the cases above, exactly what is being retired, and how retirement is documented and assured for what purposes, remain unclear. That seems true even for programs like CCX and RGGI, which apply neither nationwide nor to all major CO₂-emitting sectors within their geographic reach, and will in effect will depend on certificates that are surrogates for the underlying reductions. What happens to those underlying reductions, whether they are traded elsewhere (outside the scope of such programs), and the extent to which breaches of program-specific proscriptions³⁰ are discoverable and practicably enforceable, seem uncertain. This situation may continue at least until there are counterpart national RPS and CO₂ regulatory programs. It may continue afterwards, to the extent disconnects remain between the contents and scope of traded certificates under “import” provisions between (say) the US and the EU.

CAC has serious concerns that ill-defined concepts of what “commodities” are being “retired” for compliance or other environmentally-beneficial purposes could lead to lawsuits (by, for example, state Attorneys General) raising consumer misrepresentation or similar issues. Such developments could materially affect all carbon trading, including but not limited to RGGI. The effects could be similar to those that long have been feared, and

³⁰ For example, the draft Rule’s threshold criterion that “Projects may not be awarded credits or allowances under any other mandatory or voluntary greenhouse gas program or market.” Sec. 10.3(d)(iii).

generally avoided, by program requirements that only ERC providers --- not ERC purchasers --- must be held responsible for assuring compliance with terms defining what has been sold or transferred.³¹

We realize that SWG may not be able to deal immediately with such issues. However, **we strongly recommend that it acknowledge their existence in or with release of a final Rule, and that it commit to address them (as it has for numerous other matters) after release of that Rule.**

9. Next steps. We emphasize that within limits, it is far more important for a CO2 Budget Trading Rule to be done right, than merely to be done. We also emphasize that as past examples demonstrate, no emissions trading system can seek both to be airtight, *and* be workable, *at the start*. A trading approach with few traders and few real-world safety valves likely will not reach the point where mid-course correction remains meaningful.

Mid-course correction itself --- to the extent possible, by predictable automatic adjustment mechanisms contained in the rules --- seems a much preferable response to potential concerns that may be posed by a somewhat relaxed initial regime. It also seems preferable to the regulatory gridlock that could result if sufficient allowances for compliance are not perceived to be reliably available, shortly after the start of the first three-year compliance period.

In addition, no specific external deadline drives development of this program. We realize that considerable state-level implementation must follow for a true “program” to exist. However, by the same token there seems ample time for SWG to address remaining issues and mesh those resolutions with state implementation, as the draft Rule itself recognizes. Neither ambient air quality, nor the greenhouse effect, would seem to be materially affected one way or the other if participating states’ NOx Budget Trading regimes commenced full applicability in 2010 instead of 2009.

CAC accordingly recommends that SWG either address in a final Rule the issues raised by our comments, or expressly reserve those issues for reasonably prompt resolution by supplemental releases, after an initial final Rule is released.

The Conservancy thanks SWG for the opportunity to submit these comments. We would be pleased to discuss them further, as appropriate.

³¹ As the ETPS noted, if this principle were not rigorously adhered to, a program-undermining “complex set of third party lawsuits likely would ensue.”

Sincerely,

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