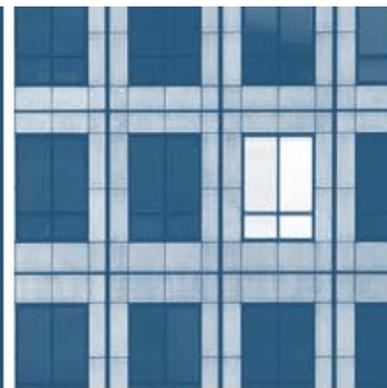


# On the Subject



## Energy & Commodities Advisory

July 27, 2010

EPA is set to issue proposed regulations in the Federal Register that would require Electrical Generating Units (EGUs) above 25 MW in 27 eastern states and Washington, D.C., to reduce emissions of NO<sub>x</sub> and SO<sub>2</sub> and EGUs in an additional four states to limit emissions of only NO<sub>x</sub>. EPA proposes to allow for interstate trading of emissions allowances under restrictions designed to ensure that each state is able to meet National Ambient Air Quality Standards (NAAQS).

### EPA Proposes New Trading Programs for Sulfur Dioxide and Nitrogen Oxide Emissions Allowances; New Programs Would Replace CAIR

Earlier this month, the United States Environmental Protection Agency (EPA) proposed regulations to replace its Clean Air Interstate Rule (CAIR). EPA's proposed Transport Rule, which is expected to be published in the Federal Register in early August, would require 27 eastern states and Washington, D.C., to reduce emissions of NO<sub>x</sub> and SO<sub>2</sub> and an additional four states to limit emissions of only NO<sub>x</sub>. The proposed emissions limits are intended to facilitate attainment and maintenance of National Ambient Air Quality Standards (NAAQS) for fine particulate matter and ozone by states that are downwind of sources emitting NO<sub>x</sub> and SO<sub>2</sub>.

Under EPA's preferred implementation plan, covered sources could engage in interstate trading of emissions allowances under certain restrictions designed to ensure that each state is able to meet the NAAQS. EPA has also presented two alternative approaches for comment. One implementation option would create a total of 82 markets for three new types of state-specific emissions allowances and would allow for intrastate trading. The other option would prohibit allowance trading entirely.

The Transport Rule would replace CAIR and associated trading programs invalidated by the D.C. Circuit Court of Appeals in *North Carolina v. EPA*, 531 F.3d 896 (2008 D.C. Cir). The proposed rule, which was released on July 6, 2010, would modify 40 CFR Parts 51, 52, 72, 78, and 97. Comments to the proposed rule are due 60 days after it is published in the Federal Register.

### Federal Implementation Plans to Reduce Emissions from EGUs

Under EPA's proposal, portions of the State Implementation Plans (SIPs) for 31 states and Washington, D.C., would be replaced by Federal Implementation Plans (FIPs) to address NO<sub>x</sub> and SO<sub>2</sub> emissions that "contribute significantly to non-attainment in, or interference with maintenance by, any other state" with respect to NAAQS. EPA's FIPs would set emissions budgets for each state and would require emissions reductions from Electrical Generating Units (EGUs) in each state to meet those budgets. EPA's state budgets, which are included in the proposed rule, and emissions limits for every covered source, which are listed in a supplementary document, would take effect beginning in 2012.

The Transport Rule would cover stationary fossil-fuel-fired boilers and combustion turbines serving a generator producing electricity for sale that has a capacity of more than 25 MWe (megawatt electric). Certain cogeneration units and solid waste incinerators would be exempted from coverage, and non-EGUs could voluntarily opt into one or more of the trading programs. Allowances allocated to an opt-in unit would be in addition to the allowances issued to covered sources from the overall state budget and could be used by any covered source for compliance purposes. EPA believes that allowing for opt-in units could encourage non-EGUs to make low-cost emissions reductions and then sell excess allowances to covered sources for compliance purposes.

### EPA's Preferred Implementation Option

EPA's preferred implementation option, entitled "State Budgets / Limited Trading", would establish four separate interstate trading programs in 2012. The programs would provide for annual NO<sub>x</sub>

allowances, ozone season NO<sub>x</sub> allowances, SO<sub>2</sub> group 1 allowances for one category of states subject to significant SO<sub>2</sub> reductions, and SO<sub>2</sub> group 2 allowances for states subject to moderate reductions. The allowances would not be interchangeable for compliance purposes. In other words, a covered source in a group 1 state would be required to hold group 1 SO<sub>2</sub> allowances, and a covered source in a group 2 state would be required to hold group 2 SO<sub>2</sub> allowances. However, any covered source could trade NO<sub>x</sub> allowances with any other covered source irrespective of whether they fall within the same SO<sub>2</sub> group.

EPA would allocate allowances to each source in 2012 based on its proportional share of the state's total emissions, with three percent of a state's total allowances set aside for new units. Each allowance would authorize the emission of one ton of the pollutant annually, or one ton during the regulatory ozone season for an ozone season NO<sub>x</sub> allowance. In group 1 states, the total number of SO<sub>2</sub> allowances would decrease in 2014. In group 2 states, the total number of SO<sub>2</sub> allowances would not change after 2012.

In addition to setting state budgets for total emissions and specific emissions allocations for individual EGUs, the Transport Rule establishes 1-year variability limits and 3-year rolling average variability limits for each state. The proposed rule would prohibit the sum of all EGU emissions in a particular state from exceeding the state budget plus the state's 1-year variability limit in any one year. Similarly, the state's annual average emissions for any 3-year period may not exceed the state budget plus the 3-year variability limit.

Beginning in 2014, trading rules called "assurance provisions" would penalize EGUs that contribute to exceedance of a state's total budget. If a particular state exceeds either the 1-year or 3-year limits, EPA would determine which source owners' emissions exceeded their share of the state budget and would subject those owners to an allowance surrender requirement. Thus, each EGU owner will have to ensure that it holds sufficient allowances to cover its emissions and that it does not hold more allowances than its proportional share of the state's total budget plus variability limits. If a state's overall budget is not exceeded, an EGU owner would not be penalized, regardless of the number of allowances it held. It should be noted that the assurance provisions would not limit intrastate trading.

### **Alternative Implementation Options**

EPA's first alternative implementation option, entitled "State Budgets / Intrastate Trading", would create separate state trading programs for each allowance and would prohibit interstate

trading. If implemented, this option would create 28 trading programs for annual NO<sub>x</sub> allowances, 26 trading programs for ozone season NO<sub>x</sub> allowances and 28 SO<sub>2</sub> trading programs. Each state would have a hard cap with no variability limits.

EPA would hold annual auctions in each state to enable companies with a market share of less than ten percent in that state to purchase additional allowances. EPA is concerned that the concentrated nature of numerous state power markets would be reflected in state allowance markets if all allowances in a particular state were distributed on the basis of generation size. Between two and five percent of allowances that would be allocated to companies with more than 10 percent of the state's total generation would be set aside for annual auctions.

EPA's second alternative implementation option, entitled "Direct Control", would require each EGU owner to meet specified average emissions rate limits and does not include provisions for allowance trading. An owner could average the emissions of its units within a particular state to meet the emissions rate limits. This second alternative option would include assurance provisions similar to those in the State Budgets / Limited Trading option to ensure that each state stays within its emissions budget.

### **Market Rules and Relationship to Other Trading Programs**

To implement the proposed rule's trading programs, EPA would utilize an allowance management system "operated essentially the same as existing systems that are currently in use for CAIR and the Acid Rain Program under Title IV." The system would include compliance accounts for covered sources and general accounts for any person that chose to participate in the trading programs. Banking of allowances would be permitted.

Under EPA's proposal, CAIR allowances allocated for periods after 2011 could not be used for compliance. Promulgation of a final Transport Rule would not affect any Acid Rain Program requirements, and Title IV sources that are subject to the Transport Rule would still need to comply with all Acid Rain provisions. However, Title IV allowances could not be used for compliance under the Transport Rule program, nor could Transport Rule SO<sub>2</sub> allowances be used for compliance under the Acid Rain Program.

Because the Acid Rain Program requirements are likely to be less stringent than those under the Transport Rule, sources covered by the proposed rule will likely meet the Acid Rain Program emissions limits as a result of complying with the stricter Transport Rule. Consequently, the allowances issued under the Acid Rain Program could be significantly devalued. Indeed,

since EPA released the proposed rule on July 6, SO<sub>2</sub> and NO<sub>x</sub> emissions allowance prices have sharply declined.

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