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David P. Novello for Clean Air Action Corp. February 22, 1995

SUMMARY OF AN "OPEN MARKET" SYSTEM

The "Open Market" system is the next step in the evolution of market-based pollution controls. Fifteen years ago, EPA introduced the "bubble" concept to allow industrial plant owners to shift emission reduction obligations within a single industrial facility among different emission sources. In 1990, Congress adopted the acid rain control system, which placed a "cap" on emissions for a limited category of sources within a closed system. The Open Market system can achieve the benefits of market-based pollution control across a broader universe of diverse pollution sources.

What is the Open Market System?

The "Open Market" System is an important innovation in pollution control technology. It is an innovative "software" solution, rather than the hardware we are accustomed to.

The Open Market system provides sources of air pollution another choice for compliance with pollution control requirements. In addition to compliance in the traditional manner through on-site pollution control measures or changes in the manufacturing process, an Open Market system allows the use of Emission Reduction Credits ("Credits"), generated by actions taken elsewhere, to comply with emission limitations.

Two concepts are the keys to obtaining the benefits of the Open Market system. The first concept is a private market in surplus discrete emission reductions. And second, making the user, rather than the creator, of these reductions, responsible to the State for their quality.

A Private Open Market in Surplus Discrete Emission Reductions.

Credits represent reductions in emissions below the lower of actual emissions or emissions levels required by federal or State pollution law, maintained over a discrete period of time, that have been officially recognized by the State for use in compliance.

Prior to official recognition, they are known simply as *Surplus Discrete Reductions ("SDRs")*. In the Open Market, these SDRs can be freely bought and sold in a private market, without government involvement. The option of buying SDRs allows air pollution sources subject to emission limitations to seek out alternatives to on-site compliance that may be less expensive.

User Responsible for Quality of SDRs.

State involvement comes when a source wishes to use SDRs as Credits for compliance. At that point, the user must demonstrate the quality of the SDRs, just as he

must demonstrate the proper performance of a pollution control device. If the State determines that the SDRs are not adequately documented, it may refuse to recognize them. At that point, the user is considered out of compliance, and is subject an enforcement action, just as if a pollution control device were not properly operated.

How Are SDRs Validated?

The creator of the SDRs is made responsible for the quality of SDRs through his contract with the buyer, rather than to the State directly. SDRs come packaged with information regarding how they were generated. The buyer bears the risk of having bought bad SDRs and so has in incentive to (1) assess the quality of SDRs offered for sale, (2) assess the quality of the verifying information included with the SDRs, and (3) adjust the "bid price" accordingly. Hence the market price of SDRs from various sources can act as a proxy for the quality and legitimacy of the emission reductions involved. As markets mature, SDR brokers, rating organizations, auditors, and insurers may emerge to further insure credit quality.

David P. Novello for Clean Air Action Corp. *February 22, 1995*

QUESTIONS AND ANSWERS ABOUT THE "OPEN MARKET" SYSTEM

How Does the System Assure that Reductions are Real, and Not Just Paper Reductions?

In the current system, only the regulator assures that reductions are real. In the Open Market system, the regulator is aided by buyer vigilance. Actual history and experience suggests that high quality SDRs drive out low-quality ones. Where actual emission reductions cannot be demonstrated convincingly to a potential buyer, they do not find a market.

But How Can a Regulatory Agency Assure That the Reductions Are Real?

Currently, regulators rely primarily on paper records to substantiate compliance with emission limitations. Regulated entities' incentive is to keep the minimum required records, and the burden of proof is on the regulatory agency.

In an Open Market system, SDR generators have an incentive to provide far more detailed and higher quality information in order to command a higher price for their SDRs. Regulators can use a buyer's purchase of below-market SDRs as indicative or presumptive of malfeasance or fraud.

In an Open Market system, the risk of rejection and potential liability for noncompliance creates buyer incentives to assure SDR quality. For sellers, commercial lawsuits from buyers provides a strong incentive to maintain SDR quality.

Creating SDRs Helps Air Quality; But Since SDRs Can Be Used for Compliance Later, How Can There Be Any Net Benefit?

Because today's air quality is worse than it will be in the future, reductions occurring today have a more positive effect on public health.

Also, one function of SDRs is to provide a compliance margin. Buyers will hold SDRs to protect them from noncompliance in the event of an unforeseen upset that increases their emissions. SDRs held for a compliance margin represent improvements in air quality.

The Open Market encourages early reductions. Sources that foresee tighter emission limitations in the future, because of the program of the Clean Air Act, have an incentive to take the needed measures early to create SDRs. These actions remove pollution from the air, improving air quality.

What About Collusion Between Buyer and Seller?

Below-market prices for SDRs will call attention to collusive or fraudulent transactions. Moreover, sellers of legitimate SDRs have a financial incentive to fight

collusion in order to preserve the value of their SDRs. Finally, buyers will have strong incentives to demand third party verification of SDRs in order to insure they will be recognized by the State.

What Prevents Sources From All Using Their SDRs at the Same Time, Thus Causing a "Spike" in Emissions that Exceeds Air Quality Standards?

There are two answers to this question. First, computer modelling indicates that as a matter of fact, this possibility is extremely remote in any real situation.

Second, if a State remains nonetheless concerned about this possibility, it can adopt regulations that prevent it. Since such regulations would tend to inhibit the market and reduce its benefits, this step should be carefully considered.

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THE BENEFITS OF THE OPEN MARKET SYSTEM

What are the Environmental Benefits of an Open Market System?

Technological Innovation. An Open Market system stimulates innovation in methods of reducing pollution. Because an Open Market means that emission reductions have economic value, the market provides an incentive to find economical ways to reduce pollution.

No More Variances. An Open Market system provides an alternative to giving variances when compliance is difficult or expensive. Variances, sometimes called "alternative emission limitations" or extensions, are an important reason why States have failed to meet clean air standards.

Direct Contribution to Cleaner Air. In an Open Market system, a source that wishes to use Credits must supply 10 percent more SDRs than the Credits required. These 10 percent are retired without use, in order to improve the air quality.

Early Reductions. In an Open Market system, sources of air pollution have an incentive to make reductions early, before more stringent emission control requirements go into effect, in order to generate SDRs in the meantime. The effect of a continuing pattern of early reductions is a permanent improvement in air quality.

Reach All Air Pollution Sources. An Open Market provides a way to cut emissions from sources that cannot effectively be reached by regulation. In the Northeast, three quarters of the sources of nitrogen oxides ("NOx") and more than 80 percent of emissions of volatile organic compounds ("VOC"), the primary constituents of the ozone smog, come from sources that are not subject to a permit requirement – sources such as cars, outboard motors, lawn mowers, and small boilers. The figures are similar for other major metropolitan areas of the country.

Better Pollution Information. Because users will demand extensive documentation of SDRs in order to be sure they will be recognized for compliance by the State, an Open Market will generate far better information about sources of emissions. In today's system, the incentive is to develop as little information as possible; in an Open Market, SDR creators will have an incentive to provide extensive documentation, in order to assure the salability of their SDR "product."

What Are the Benefits for Industry of an Open Market?

Industry benefits because an Open Market provides a means of complying with emission limitations at the lowest cost. Companies with high compliance costs can use Credits for compliance; where emissions reductions are cheap, the creation of SDRs can be an income producer.