New Source Review ERC trading – the good, the bad and the difficult

Regional emissions offset programmes vary greatly and pose different challenges to industry and government alike. **Anthony Arcone** and **Josh Margolis** highlight the positive aspects of such programmes and recommend some changes

The Acid Rain SO_2 and the Ozone Transport Commission's NOx emissions trading programmes get plenty of attention from traders, regulatory agencies and consultants. Major players know the rules and reconciliation periods and can quote the markets regularly. Roughly 3 million tons of current vintage SO_2 and NOx emission allowances are transacted every year. These programmes have been the focus of hundreds of papers, most of which have concluded that they are models against which all other emissions trading programmes should be compared.

The same cannot be said for the New Source Review (NSR) emission reduction credit (ERC), or offset programmes. In place since the late 1970s, these programmes govern major new sources of emissions – including NOx, SO_2 and volatile organic compounds – and major modifications of existing sources in areas failing to satisfy the National Ambient Air Quality Standards. In addition to mandating the use of lowest achievable emissions rate technology for such sources, the programmes mandate sources to obtain emission reductions (generally at a greater than 1:1 ratio) from other sources in the applicable air-shed to mitigate the emissions increase.

Though overseen loosely by the US Environmental Protection Agency, these NSR programmes are developed and administered by states and local air districts. Unfortunately, the rules vary in their scope, content and requirements between states and, in the case of California, between air districts (California has 35 air districts, each of which has its own set of programmes). Some NSR ERC trading programmes work quite well; others do not. A review of the good, the not-so-good and the difficult elements may be the starting point for beneficial changes.

The oldest and most active offset programmes are on the east and west coasts of the US. Here too, we find extremes in programme quality. Much of what makes an ERC trading programme successful is found in the programme's emissions bank (or the lack thereof) – an administrative mechanism allowing sources to gain recognition for ERCs and store them for later use or sale.

Well-run banks allow potential sources seeking offsets to clearly view the quantity and type of banked ERCs, their method and date of creation, and any use restrictions. Some banks are even available online and updated monthly. Flawed banks leave out critical information, fail to address the amount by which ERCs have been, or could be, discounted to account for new rule changes, or have a poor track record in reviewing and certifying new ERCs and transfers in a timely manner.

Good programmes are clear about the ERCs' past and future discounted values from the time they are banked until they are subsequently reapplied to a new source's air permit. Offset programmes can elect to preserve all ERCs at their face value or discount them to account for technology and regulatory changes that would have affected the source from which the ERCs are derived. If the programmes do discount ERCs, prospective buyers (and sellers) should be able easily to calculate the amount of product remaining so as to know what each party is transacting.

Expeditious reviews of ERC use applications are more likely if the bank clearly specifies the criteria against which application and transfer requests are to be evaluated. The absence of such criteria leaves applicants to guess at, rather than objectively decide, the quantity of ERCs that may be banked and later sold, which also adds uncertainty to the contract process. Regulators, with the same loose protocol, are more apt to either deny recognition of valid emissions reductions or apply extraordinarily harsh evaluation criteria resulting in a high proportion of ERC application denials. Or, in the absence of clear approval and transfer criteria, regulators may allow transfer requests to fall to the side in favour of mandatory and/or more clearly enunciated requirements within the programme.

Outstanding offset programmes provide for the quick processing of ERC applications and trade requests. Ideally, applications should be reviewed and approved or denied within a month – two months at the most. In reality, some applicants wait a year or more to find out if their application is approved, resulting in plenty of time for a short market to appreciate three to four times (as has happened in some regional markets in the past year). This type of regulatory risk is hard to price into call option agreements, which often begin the process of an ERC transaction between uncertain buyers, and likewise, uncertain sellers. Is it a month-long option, or a year? Will the product ever materialise? Who bears the risk if the contracted-for ERCs are not approved? Similarly, trade requests should be accomplished in two to three weeks, not 10 to 12, the best that some programmes can manage. Lack of timeliness on the part of these programmes exposes both parties to counterparty credit risk, cost of capital considerations and the sometimes incalculable regulatory risk that neither side likes to take, which is still prevalent even after the ERCs have been approved, as mentioned above.

What makes a good NSR ERC trading programme? Regulatory certainty, which means a well defined set of rules governing what is bankable, a simple transfer process, and regulators that are expedient at answering questions and processing transfers. These factors will give comfort to counterparties in transacting more actively and will promote emissions trading across all products, not just the established SO_2 and NOx allowance markets.

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