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Submittal of PEER Executive Director Jeff Ruch
To the
Clean Air Act Advisory Committee

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SUBJECT: Failure of EPA's Market-Based Trading Programs — Request for Intervention by the Clean Air Act Advisory Committee

Public Employees for Environmental Responsibility (PEER) is a national service organization for federal, state and local government employees to foster environmental protection. Among the services PEER provides is to act as a spokesperson for agency employees who are constrained from publicly disclosing matters of concern.

It is that capacity that I am here today.

The Clean Air Act Advisory Committee occupies a very important position in the protection of public health in the United States. The Committee's advisory role is especially crucial now in light of the Environmental Protection Agency's repeated refusal to heed the findings and advice of its own Inspector General on the matter of the use of so-called trading programs for compliance with the public health requirements of Title I of the Clean Air Act.

PEER's comments are instigated in particular by the collapse of the New Jersey trading program, the September 30, 2002 report by the Inspector general on open market trading programs, and the Agency's response to the IG (or more accurately, the lack thereof). **In addition, the Agency's manipulation of its own trading guidance in recent actions in Baton Rouge, Louisiana suggests that a new, under-the-table form of trading may be on the horizon.** Finally, the Committee should take note of attempts by Agency management to take punitive actions against employees who have challenged these actions.

REQUEST FOR CLEAN AIR ACT ADVISORY COMMITTEE INTERVENTION

PEER requests that the Committee intervene, review and advise the Agency on the following issues:

1. Agency requirements and guidance should be revised to address the flaws identified in the IG's several investigations, extending from 1996 to the present. Open market trading (OMT), in all of its forms and regardless of how it is labeled, should be subject to binding requirements and guidance.

2. Outstanding proposals for federal approval of OMT programs, including the Michigan proposal of February 2001, should be withdrawn pending revision of the Agency's OMT requirements.

3. Oversight of trading programs, at the federal and state levels, should be systematized and protocols for oversight and evaluation developed. While trading programs may be "voluntary," compliance with the Clean Air Act is not. The Agency refusal to provide oversight is unacceptable.

4. Agency abuse and avoidance of application of its own guidance, most egregiously engaged in by the Agency in the recent Baton Rouge actions, should be investigated and procedural safeguards instituted to avoid repeat of such abuse.

5. EPA's grant of amnesty to New Jersey sources relying on illegal credits should be reversed.

6. The CAAAC should join with the National Environmental Justice Advisory Committee (NEJAC) in reviewing the Agency's implementation and oversight of community and environmental justice safeguards in the Agency's trading programs.

7. The Clear Skies proposal should be reconsidered in light of the failings of the New Jersey program, open market trading and the "market model" of compliance.

8. Retaliatory actions against employees raising legitimate concerns should be investigated and corrected.

In pursuing these matters, the Clean Air Action Corporation and its officers should be recused.

DISCUSSION

A. EPA Intransigence to the Inspector General's Findings

As the Inspector General (IG) noted in the current report, this was not the first time IG looked into these issues, but in fact the fifth in a series of related reports. The first was a 1996 report, entitled "EPA's Development of its Proposed Open Market Trading Rule" (March 28, 1996), which was followed by several other reports on quantification, enforcement and so on. This was an excellent report (copy attached) that provided a clear warning on the dangers of weak quantification procedures, a "buyer beware," hands-off approach to compliance. While the

collapse of the New Jersey program confirms the validity of these concerns, the Agency remains unmoved, refusing to commit to changes in its policies and indeed promising even more open market trading in the future.

As with the latest report, in 1996 EPA rejected the IG's suggestions, with Office of Air Quality Planning and Standards (OAQPS) director John Seitz taking the position that "Mary Nichols (Assistant Administrator for air) and I remain committed to developing a model rule which minimizes the Federal government's operation of the market for these trades." As the IG's latest report shows, even calling EPA's role "minimized" is an overstatement.

PEER has previously put forward its concerns in 1999 comments on the then proposed EPA Economic Incentive Program (EIP) guidance, and in June of 2000 issued a white paper, ***Trading Thin Air***, detailing the questionable policy base of OMT and challenging the Agency to rectify the weaknesses in these programs. In February 2001 PEER and the Sierra Club (New Jersey) requested investigation by the IG of the Agency's continued advocacy of these programs, most egregiously the cases of New Jersey and Michigan, but also other programs in Illinois and California. (Referenced PEER documents are attached.)

One and a half years ago, on May 31, 2001, twenty environmental and community-based organizations requested that EPA Administrator Whitman impose a moratorium on all usage and action on open market trading programs. The Agency has yet to respond to this petition.

The IG subsequently initiated this investigative work, which has since been broken down into phases, the first of which is the "integrity" report issued on September 30, 2002, the second of which is on the environmental justice (EJ) effects of these programs, with that report due out perhaps not until next year.

Let me remind the Committee that until the IG's "integrity" report was in final draft form, EPA was still trying to grant federal approval to the New Jersey program. Only after the state of New Jersey stated its intent to terminate the program did EPA agree to withdraw its ill-conceived proposed approval. Nevertheless a similarly ill-conceived Michigan program remains proposed for approval by the Agency. It is a matter of urgency that the Committee advise the Agency against any further pursuit of these ill-advised policies until they have been revisited and corrected.

B. Binding and Enforceable Requirements Should Be Imposed on Emissions Trading.

While trading programs may be "voluntary," compliance with the Clean Air Act's requirements is not. Performance standards for open market trading must be developed and imposed as requirements. Standards need to be developed for all aspects of compliance. The IG's reports in 1996 and this year were both plain in stating the case for binding requirements and the hazards of not imposing such requirements. New Jersey has proven the case.

Compliance with the Clean Air Act should not be voluntary

It is time to cut to the chase on what this ongoing trading shell game is about. First, despite all the fog about "incentive programs," and "harnessing the market," **the kinds of trading programs under discussion here are, in reality, alternative compliance tools**. Given that frame of reference, it then becomes clear that the purpose of the OMT initiative over the last decade (since the Demonstration Project in the Northeast) has been to finesse the question of compliance. Buried among all the verbiage over "verification" of credits, whether it should be on the "front end" or "back end," and which approach would least "inhibit the market" is an evasion in order to avoid the question of who (if anyone) would be responsible for compliance.

Thus, much of the debate, and the resulting deadlock over a never-issued OMT rule was about who would deal with compliance, and when. Now we know the answer: Nobody. Under OMT, Nobody is responsible for compliance. Unfortunately for the Agency, that posture is contrary to the Clean Air Act; the requirement that there be adequate resources committed to implement and enforce the program is a core requirement of the Act, plainly stated at section 110(a)(2)(E). Responsibility can no longer be escaped — somebody has to do the necessary technical work, inspections and compliance determinations.

The reality is, as learned in the RECLAIM program out west, as others are learning elsewhere, **compliance under a trading scheme is *more* difficult, is *more* complex, requires *more* resources.** This is no longer in doubt, but what is in doubt is whether the Agency has the will to face up to this reality.

OMT must be regulated in all of its guises.

OMT exists in programs operating under many different rubrics (i.e., cap-and-trade, hybrids). Regardless of how it is packaged, OMT must be subject to the same safeguards needed for pure OMT programs. Repackaging and re-labeling should not be allowed to substitute for effective management. The Illinois program is an example of a program that is in large part OMT. Recent modifications to the South Coast's RECLAIM program also raise this concern.

An example of this repackaging is evident from a reading of the January, 2002 report by Clean Air Action Corporation (CAAC) to the Canadian government, "U.S. Experience with Emissions Trading" (available at http://iisd1.iisd.ca/climate/detwg/detwg_us_final_report.pdf). Two things jump out at the reader:

> One, the lack of success of OMT is attributed primarily to backward and entrenched bureaucrats at EPA who needlessly impose excessive constraints on the program.
>
> Second, since OMT has become somewhat of a lightning rod on its own, it will now use the protective camouflage of being a "hybrid" cap and trade program.

CAAC refers to two examples of the worthiness of such a disguise — the Illinois trading program and California's RECLAIM program, which had recently been leveraged open by way of a so-called "energy crisis" (since confirmed to be in large part more of a manipulation than a crisis). While PEER has maintained that the Illinois program is simply OMT in disguise, it is even more disquieting that the one potentially valid form of trading, "cap and trade," may now be undermined by the very same approach that brought us the New Jersey fiasco.

C. Oversight Has Been Nearly Nonexistent.

As the IG report noted, oversight of OMT in New Jersey was virtually nonexistent at either the state or the federal level. EPA remains unchastened, proudly proclaiming that oversight would have been premature prior to federal approval of the trading program. This argument ignores the fact that the program was in operation for six years, during which time it was used to comply with requirements that had already been federally approved.

Oversight of trading programs, at the federal and state levels, needs to be systematized and defined. The periodic evaluation requirements for economic incentive programs (EIP), described generally in the Agency's EIP guidance but then accepted in very weak form by the Agency in several proposed state approvals need to be revisited and strengthened in light of the New Jersey failure and the IG reports. .

D. Amnesty for Abuses in New Jersey Is Inappropriate

EPA's blanket "good faith" enforcement amnesty for New Jersey sources benefiting from the illegitimate credits of that state's program should be reversed and enforcement actions pursued. As shown by the lengthy series of IG reports, comments by our organization and others over the past several years, and internal documents previously released under the Freedom of Information Act and reported on in our various reports, there were no real surprises in the failure of the program. The only "faith" demonstrated by these users was in the ability of political and corporate operatives to duck responsibility.

As a consequence, thousands of tons of required emission reductions never occurred. The citizenry of New Jersey paid a real price in public health for these deals, and there should be consequences.

Blanket amnesty is at least ironic in the face of the Agency's relentless hyping of self-policing "market forces." Now when it turns out no one at all was paying attention, no one is accountable and the detriment of pubic health in New Jersey will not be penalized.

In February of 2001 PEER requested enforcement action against sources that had availed themselves of the illegal and inappropriate relief provided by OMT programs in New Jersey. Other than acknowledging the receipt of our request, EPA Region II has not responded. This past summer, in correspondence with New Jersey Environmental Commissioner Brad Campbell,

EPA Region II signaled its desire to shield the ten or more sources who materially benefited from the ill-conceived New Jersey OMT program (See Correspondence, EPA to New Jersey DEP, September 10, 2002).

E. The Agency Continues to Avoid Its Own Trading Guidance - Baton Rouge

During the winter and spring of 2002 the Agency's air and trading offices responded to a proposal by Louisiana, to add a new twist to the oldest and original form of trading: offsets for New Source Review (NSR). However, the Agency quickly discovered that the interprecursor trading features of the program would run afoul of the Agency's own guidance for EIPs regarding "hot spots" (localized increases in pollutants) and environmental justice.

Louisiana proposed, for the Baton Rouge area, that increases of volatile organic compounds (VOCs) could be offset by decreases in oxides of nitrogen (NOx). The problem with this for the affected communities is that the decreases of the relatively non-toxic NOx would not offset the toxic components of the VOCs.

The hot spot and EJ aspects of VOC trading have been a matter of national controversy for at least the past six years, one result being that the Agency's EIP guidance includes several sections describing "required" safeguards for EIPs involving VOCs. EPA's Dallas office (Region VI) asked the Agency trading chief, Ron Evans, whether this would be a problem. In documents which are attached, it is clear **the head of the Agency's trading programs overruled his own staff experts and took the insupportable position that the programs were not trading and were not market-based, and therefore were not subject to the EIP guidance**.

In a bit of reasoning described by EPA staff as "achieiv(ing) levels of obfuscation that would make an Enron attorney proud," Mr. Evans position was put forward in the Federal Register in a July 23 proposal, finalized on September 27 of this year. (Staff memorandum, September 11, 2002, attached.) While the Agency's reasoning was ludicrous, the effects are anything but trivial. As representatives of Baton Rouge communities noted in their comments on the proposal, the trading rules "will disparately impact Louisiana's already overburdened African Communities along the Baton Rouge Corridor." (August 26, 2002 comments by the Tulane Environmental Law Clinic, submitted on behalf of the Louisiana Environmental Action Network (LEAN).)

This flagrant abuse of the Agency's own guidance was challenged not only by Evans' own staff but also by other offices in the Agency. As described in greater detail below, the response of Evans and others was to seek punitive actions against objectors.

The Committee should join with the NEJAC, as it did during development of the EIPs hot spot and EJ safeguards, in following up on the issues of community-specific and EJ impacts of trading programs, and of the Agency's deeply entrenched resistance to addressing these issues.

Unfortunately, Baton Rouge is but one example of, albeit a particularly egregious one, of not only the hazards of such programs, but the lengths to which the agency will go to avoid the issues. The Agency's air program has abandoned the safeguards included in the 1999/2001 EIP and excluded the Agency's Office of Environmental Justice from any role in either the specific rulemakings or oversight of the policies.

F. The Trading "Market Model" for Compliance Is Fundamentally Flawed.

Open market advocates have been adamant that the market would be essentially self-policing:

- In remarks generally attributed to Rob Brenner, EPA said "the EPA believes that the principle of buyer beware liability will work best to assure (credit) quality." (August, 1995 proposal of OMT rules.)

- Clean Air Action Corporation's Ben Henneke said "EPA should not attempt to develop protocols...measurement issues can be resolved by market decisions..." ("OMTR Issues and Potential Solutions," February 1996).

- Clean Air Action Corporation's attorney, Richard Ayres, of O'Melveny and Myers lauded "the open market system (because it) in effect deputizes the buyer's commercial interest to assure the environment is protected."

Buyer beware has now been shown to be a myth. Not only did the market fail to perform as predicted in New Jersey, but also the fallback "third party" has disappeared and the buyers, far from having to be "beware," are instead being granted blanket amnesty.

In another particularly ironic point, Mr. Henneke stated, "If you end up with a clear enforcement policy...that will be a clear signal...consistent enforcement...is also going to be terribly important." (Testimony, OMTR public hearing, August 31, 1995.) Following the logic of that comment —

- What kind of "signal" is the amnesty for New Jersey?
- What kind of signal is the lack of response by Mr. Brenner and his Agency to the IG report?

If anything, the past year's and financial news have shown that many assumptions about how "free markets" and "trading" work have been at least overly optimistic, and often just plain wrong. Stock and money market figures are charged with corporate misbehavior and the sight of executives being led away in handcuffs has become a daily staple. So it is timely to ask, in the pollution credit markets — which trade on public health requirements — why is the response so cavalier? Why is it acceptable to trade in bogus currency in public health protection, why is this taken so much less seriously? Is it that public health is in fact much less important than money?

The Agency's market-based model of compliance has failed. It should be corrected before public health protections are further eroded.

G. The Agency's Clear Skies and NSR Reform Programs Should Be Reconsidered in Light of the IG Reports and Experiences in Other Title I Trading Programs in New Jersey, Michigan, Illinois and California.

All of the events noted above are occurring at a time when the Agency is promoting cap-and-trade as an anti-pollution panacea. Clear Skies is being touted by the Agency as the replacement for the oldest and most effective of any Clean Air Act programs — new source review for the utility sector. And under the guise of "reform" much of the remainder of NSR is being replaced with "caps" in the form of "plant-wide applicability limits" (PALs).

As noted earlier, the stakes in these programs under title I are public health. This is different than the stakes in the acid rain program under title IV, and the level of vigilance should be adjusted accordingly. There are only two nominally cap-and-trade programs of any duration operating with Title I approval. These are the South Coast's RECLAIM program and the Illinois Emission Reduction Market System (ERMS). The Illinois program has completed one cursory annual review, and the Agency is just now completing an in depth review of the RECLAIM program.

Until the Agency's market-based model has been reviewed and corrected in light of the New Jersey failure, the IG reports, and in-depth review of RECLAIM, ERMS and other programs, the stakes for pubic health under NSR Reform and Clear Skies are much too high for such a gamble.

H. Agency Management Has Pursued Retaliatory Actions Against Staff Dissidents.

When professional staff experts at another EPA Regional office questioned the Baton Rouge proposal in an internal memo (September 11, 2002, referenced earlier and attached), the head of EPA's trading programs, Ron Evans, and other Agency management sought disciplinary action against that staff. Further, Region VI Counsel accused the staff member of orchestrating a media campaign on the issue, when in fact no such campaign was either attempted or accomplished.

This internal tantrum by the Agency did result in the documents being leaked to PEER from a number of offices other the office of the employee who challenged the Baton Rouge action.

Retaliatory activities and professional assaults as carried out by Mr. Evans, the Region VI counsel and other Agency management should be stopped. Mr. Evans' involvement in these activities, and in overruling his staff experts in the case of Baton Rouge, should be investigated and appropriate corrective actions taken.

I. The Committee Should Establish a Special Sub-Group to Pursue These Issues.

The Agency has shown itself intransigent and unwilling to be responsive to the failings of the program or the IG's reports. The IG has done what it can in making its findings. There is no other oversight of the Agency's implementation of the Clean Air Act short of Congressional oversight. While such oversight is needed here, there are advantages to a professional advisory body engaging these issues and providing its views to the Agency.

J. The Clean Air Action Corporation and Its Officials Should Be Recused from Committee Consideration of These Issues.

There is a third phase of PEER's requested IG investigation that has not yet been initiated and that goes to the heart of the Agency's intransigence on these issues. That is the fatal conflict of interest between private interests who conceived and materially benefited from these programs and the public health agency, i.e. the EPA, which is supposed to oversee the programs.

PEER outlined the basis for this allegation in its February 15, 2001 request for investigation, describing how senior Agency management had granted exceptional access to the Agency=s policy and rulemaking processes by the Clean Air Action Corporation, basically allowing the Corporation and its legal representative to write the Agency's policies.

With all due respect, the Clean Air Action Corp and its officers who are members of this Committee, and indeed co-chair the Subcommittee on Economic Incentives, should remove themselves from this advisory effort. The Corporation's role in developing the policies, brokering the deals, and benefiting monetarily from the program in the now collapsed New Jersey program renders its position too compromised for it to be part of a credible advisory role.

Attachments

I. EPA's Development of its Proposed Open Market Trading Rule, IG, March 28, 1996
II. PEER comments on EIP, November 30, 1999
III. Trading Thin Air, June, 2000
IV. Request for OIG investigation, February 15, 2001
V. PEER comments on Illinois, NJ, Michigan and NH OMT proposals, March 8, 2001
VI. Request for Moratorium on OMT, 20 organizations, May 31, 2001
VII. Baton Rouge materials
    A) OAQPS e-mail on EIP applicability, May 2002
    B) Comments by TELC/LEAN, August 26, 2002
    C) Region 9 memorandum, "Emissions Trading and Environmental Justice", September 11, 2002