



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY

OFFICE OF INSPECTOR GENERAL
1200 Pennsylvania Avenue, NW
Room 3301 NE Mall
Washington, DC 20460

April 5, 2002

MEMORANDUM

SUBJECT: Observations on the Use of Shutdown Credits in
Michigan's Air Emissions Open Market Trading Program

FROM: J. Rick Beusse /s/
Director for Program Evaluation, Air Quality Issues

TO: Jeffrey R. Holmstead
Assistant Administrator for Air and Radiation

In connection with our in-process evaluation of EPA's Air Emissions Open Market Trading (OMT) Program, we recently conducted fieldwork at Michigan's Department of Environmental Quality. Below are observations we wish to bring to your immediate attention.

Use of Shutdown Credits May Be Contrary to EPA Guidance

Michigan's Emission Reduction Credit Trading program (hereafter referred to as its OMT program) allows the use of shutdown credits in attainment areas. (In essence, shutdown credits result when permitted sources reduce emissions by closing facility operations or product lines). In March 2002, EPA indicated that it intends to approve Michigan's OMT program, as revised in 1999, including the use of shutdown credits. The basis for approving OMT programs since January 2001 has been EPA's "Improving Air Quality With Economic Incentive Programs" guidance document, EPA-452/R-01-001, January 2001 (hereafter referred to as EIP guidance), which does not characterize emissions reductions from shutdowns as surplus. According to the EIP guidance, before emissions credits are eligible for inclusion in an emissions trading program, they must not only be surplus but must also meet three other fundamental integrity elements (quantifiability, enforceability, and permanence). In apparent contradiction with the EIP guidance, EPA considers Michigan's shutdown reductions as eligible for inclusion as credits in the State's OMT program.

While in Michigan, we observed that approximately 23 percent of the State's total open market emission credits generated - - and 80 percent of its volatile organic compound (VOC) emission credits generated - - have resulted from shutdowns. Further, we noted that shutdown credits have been used in Michigan's program. Under the Michigan OMT program, closed facilities are allowed to generate emission credits for 5 years from the year in which the facility closes. Since OMT credits under Michigan's program are valid for 5 years after the year in which they are generated, closed facilities can generate credits - - and credit buyers can use those credits - - over a period of almost 11 years after the facility's operations are closed.¹

Additionally, under Michigan OMT rules, when permitted sources close facility operations in Michigan and receive emissions credits for shutdowns, these same or similar facility operations may be restarted in other states (if allowed by the applicable state(s)). In this scenario, sources could be, in effect, shifting their air emissions elsewhere while generating shutdown credits in Michigan, which then may also be sold to other companies in Michigan. EPA has acknowledged that, under this scenario, overall emissions may increase and that "A ... this is clearly a detriment to the environment."

Key Events in EPA's Consideration of Michigan's Proposed OMT Program

We recently discussed the above matters with key officials from the Air Programs Branch, Air and Radiation Division, EPA Region 5, and the Office of Air Quality Planning and Standards. We learned that Region 5 initially opposed the inclusion of shutdown credits in Michigan's 1996 OMT program proposal. However, in 1997, the Office of Air and Radiation took the position that the use of shutdown credits could be allowed under EPA policy if Michigan met certain conditions. Based on this position from EPA Headquarters, Region 5 has offered Michigan three options: (1) prohibit shutdown credits; (2) allow shutdown credits but prohibit their use in non-attainment or maintenance areas; or (3) demonstrate that the use of shutdown credits would not be contrary to their attainment or maintenance plans. Michigan chose option 2 - - to allow the statewide generation of shutdown credits while prohibiting their use in non-attainment or maintenance areas. However, option 2 appears to be contrary to the final EIP guidance issued in January 2001.

Since EPA tentatively accepted Michigan's shutdown credit proposal prior to the issuance of EPA's January 2001 EIP guidance, Region 5 chose not to require Michigan to modify its proposal based on this subsequent EPA guidance at that time. We understand that Region 5 anticipates giving final approval to the existing Michigan proposal in the near future with the possibility of revisiting the issue of shutdown credits in future revisions of Michigan's OMT program.

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Given the precedent-setting nature of approving open market trading programs, the magnitude and longevity of shutdown credits in the Michigan program to date, and the difficulty of withdrawing federal approval of State Implementation Plan revisions once made, we believe that EPA's final approval of Michigan's OMT program should include a careful consideration of the shutdown credit issue at the EPA headquarters level. Once the shutdown credits are "grand-fathered" into a state's program, they may be more difficult to eliminate later. Additionally, once a precedent is established that allows the

¹The maximum period would be 10 years and 11 months.

generation and use of shutdown credits in open market trading programs, other states may wish to adopt similar policies.

If you or your staff have any questions, please call me at (919) 541-5747, or John Bishop, RTP Audit Manager, at (919) 541-1028.

cc: John Seitz, Director, OAQPS

Thomas V. Skinner, Regional Administrator, EPA Region 5