Southern California's Once Groundbreaking Cap and Trade Program is Now Riding Towards the Sunset

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The days are numbered for one of the country's first air emissions cap and trade programs. On March 3, 2017, the South Coast Air Quality Management District ("SCAQMD" or the "District") Governing Board (the "Board") approved an Air Quality Management Plan ("AQMP") that would phase out the Regional Clean Air Initiatives Market ("RECLAIM") program for 2XX stationary sources located throughout Southern California and replace it with a more traditional "command and control" regulatory framework. The District adopted RECLAIM in 1993 to provide a flexible, market-based compliance program for the largest emitters of oxides of nitrogen ("NOx") and oxides of sulfur ("SOx") by allowing major stationary sources to trade NOx and SOx credits under a cap on total emissions. Innovative at that time, RECLAIM served as a precursor for other cap & trade programs, including California's AB32 cap & trade program for greenhouse gas ("GHG") emissions.

District staff, with input from a broad and diverse stakeholder working group, has started the difficult task of fleshing out what the post-RECLAIM regime will look like. A flurry of rulemakings have already begun, and the District has released drafts of the first proposed changes to the rules early in November 2017 that staff has indicated it would like to bring to the Board as early as January 2018. A multitude of additional rulemakings, driven both by the AQMP direction and AB 617, will create the post-RECLAIM landscape and are likely to come quickly thereafter. These new rules will target both specific types of equipment (such as heaters, boilers and glass melting furnaces) and entire industries (such as petroleum refineries and electric generating facilities).

This article provides an overview of the history and current structure of the RECLAIM program, followed by an examination of the District's proposal for phasing out the RECLAIM program.

I. A BRIEF HISTORY OF RECLAIM

A. Legal Background and Authority

Although the federal Clean Air Act ("CAA") is the overarching federal law governing air emissions in the United States, primary authority for the regulation of emissions from stationary sources in California rests with local and regional air quality management districts and air pollution control districts, such as the SCAQMD. The SCAQMD has authority over stationary sources located in all of Orange County and the non-desert portions of Los Angeles, Riverside and San Bernardino Counties.

Pursuant to the CAA, the United States Environmental Protection Agency ("US EPA") establishes health-based national ambient air quality standards ("NAAQS") to protect public health. NAAQS apply to criteria pollutants: particulate matter, ground-level ozone, carbon monoxide and lead, in addition to SOx and NOx (the two pollutants regulated by the District's RECLAIM program). Areas of the country where air quality meets the NAAQS are attainment areas subject to the "PSD" program; nonattainment areas are subject to nonattainment "New Source Review."

US EPA and the states partner in regulating criteria pollutants. States and localities come up with plans; states are responsible for developing enforceable state implementation plans ("SIPs") to meet the NAAQS. In California, local air pollution districts work with the state to produce air quality plans and issue facility permits. Each air district, including the SCAQMD, periodically develops and adopts an AQMP, a plan for attaining state and federal air quality standards.

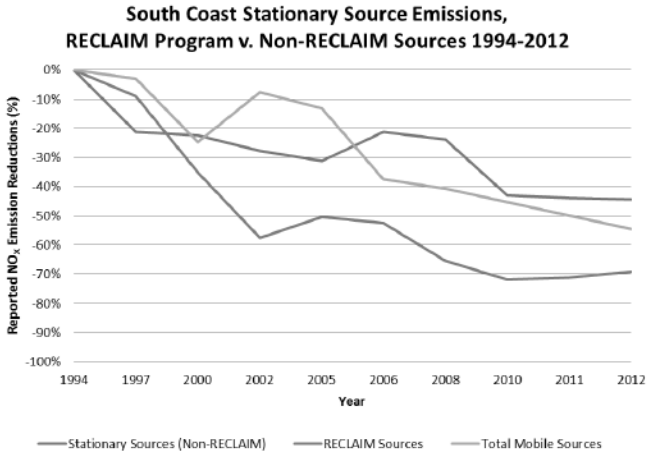
AQMPs are implemented through rules and regulations that limit emissions from affected facilities. State law sets forth certain requirements that must be included in rules and regulations adopted to implement AQMPs, including specifically with respect to the District, the requirement that existing stationary sources achieve a level of emissions reduction that is reflected by "best available retrofit control technology," or BARCT. BARCT is defined as "an emission limitation that is based on the

maximum degree of reduction achievable, taking into account environmental, energy and economic impacts by each class or category of source."

Air districts may adopt market-based incentive programs as an element of their AQMPs, and such market-based incentive programs may substitute for more traditional command and control regulations. State law requires these incentive programs, like RECLAIM, to achieve, in the aggregate, equivalent or greater emission reductions, at equivalent or less cost, as compared to command and control regulations that would have otherwise been in place and required installation of BARCT. Because BARCT is an evolving standard that becomes more stringent over time as technology advances, the incentive programs must be periodically amended to ensure that emissions reductions achieved by the program are keeping pace with advances in BARCT. This periodic evaluation and amendment process is commonly referred to as maintaining "BARCT equivalency." and facilities that are considered to have achieved current levels of BARCT equivalency are referred to as "at BARCT."[1]

B. Background and Program Success

The District Governing Board adopted the RECLAIM program on October 15, 1993, and it went into effect at the beginning of 1994. RECLAIM is a market-based cap and trade program aimed at reducing NOx and SOx emissions by imposing program-wide mass emissions caps that decline over time. RECLAIM facilities are required to provide to the District emissions credits commensurate to their emissions. At the start of RECLAIM, the District allocated emissions credits to facilities subject to the program based on each facility's historic emissions and emissions factors the District developed for the equipment operated by each facility. The District allocated the emissions credits, referred to as RECLAIM Trading Credits or RTCs, in tranches Each facility received one tranche good for each emissions year. For every given facility, the size of the tranche declines year over year—in tandem with a decline over time in the size of program-wide NOx and SOx emissions caps. As such, as the caps tighten over time and as facilities receive smaller allocations of RTCs each successive year, RECLAIM facilities have been required to reduce their NOx and SOx emissions (on a program-wide basis).[2] Under RECLAIM, if a facility wishes to emit in an amount greater than allowed by the emissions credits the facility is freely allocated, the facility must purchase emissions credits from another facility that has a surplus. The theory behind RECLAIM is that it will achieve the lowest-cost emissions reductions (and have less of an economic toll than command and control regulations), as if facility A can reduce emissions more cost-effectively than facility B, facility A is incentivized to do so and sell its excess RTCs to facility B. RECLAIM was in fact highly successful in reducing emissions program-wide, achieving a reported 69 percent decline in emissions since its inception. During that same period, non-RECLAIM stationary source emissions declined by about 44% and mobile source emissions declined 55%.[3]



Despite the program's success in reducing emissions from many of Southern California's large stationary sources, the District began to explore the potential to sunset the RECLAIM program as it moved forward with its 2016 AQMP planning process.

C. The 2016 AQMP: The Beginning of the End for RECLAIM

In December 2016, District staff issued a final draft 2016 AQMP, one focus of which is compliance with the ozone NAAQS. The District concluded that, in order to meet ozone standards, both NOx and volatile organic compounds ("VOC") emissions need to be reduced, but that NOx reductions are of greater importance for meeting ozone standards and will also lead to significant improvement in PM2.5 concentrations. To address NOx RECLAIM facility emissions, the 2016 AQMP included Control Measure CMB-05, which originally called for a further NOx reduction of 5 tpd, to be achieved no later than 2031. The 2016 AQMP also provided that options should be developed for sunsetting the RECLAIM program and transitioning back to a command and control regime.

At a March 3, 2017, meeting, the District Governing Board adopted an amendment to CMB-05 requiring that the 5 tpd reduction included under CMB-05 be achieved by 2025—six years faster than under the original control measure proposed by District staff. Crucially, the amendment also mandated that the NOx RECLAIM program be transitioned to a command and control regulatory structure with BARCT-level controls as soon as practicable. After adopting the amendment, the Governing Board passed a resolution certifying the 2016 AQMP at the same meeting. The amendment accelerating CMB-05 was incorporated into the final version of the 2016 AQMP, which is currently in effect.

The 2016 AQMP leaves a number of unanswered questions for facilities subject to the NOx RECLAIM

program. While no additional new amendments addressing NOx RECLAIM have been passed at the time of this writing, as detailed below, SCAQMD staff has been conducting a series of RECLAIM working group meetings and rulemakings over the course of 2017, which provide some insight regarding the first steps the District will take toward sunsetting the RECLAIM program.

II. SHRINKING THE RECLAIM UNIVERSE: UPCOMING RULE 2001 AMENDMENTS

District staff expects that there will be a series of amendments to District Rule 2001 (which governs when a facility is subject to RECLAIM) over the next 18-24 months that will serve as the first steps in shrinking the RECLAIM universe. District staff released a draft of the first proposed amendment in November 2017, which it expects to bring before the Board in January 2018. As currently proposed, the Rule 2001 amendment would remove the requirement that that the place facilities emitting 4 tons or more of NOx per year into RECLAIM and remove the option for a non-RECLAIM facility to enter the program. Written comments on these proposed amendments are due November 22, 2017.

Staff has also indicated that it will proposed further amendment to Rule 2001 throughout the transition process. More specifically, Staff has proposed amending the Rule in the near term to transition out those RECLAIM facilities that the District believe are presently at BARCT. The District has indicated that amendments to Rule 2001 expected to be heard by the Governing Board in March 2018 would force out of RECLAIM forty-three current RECLAIM facilities, whose emissions the District believes are presently at BARCT. In other words, the District believes that all the NOx emissions sources at these facilities are subject to non-RECLAIM rules that appropriately govern their emissions and that no new rulemaking will be needed to set emissions limits applicable to these facilities once they exit RECLAIM. These facilities' emissions represent approximately 1% of the 2015 RECLAIM market.

Following the transitions of these facilities, Staff will move forward with an amendment to remove those RECLAIM facilities the District believes are largely at BARCT, outside of certain sources at these facilities subject to District Rules 1146, 1146.1 and 1146.2 (governing boilers, steam generators, process heaters and water heaters). The District has indicated an intent to update these rules to assure that they set BARCT limits and to allow facilities a runway to come into compliance with the limits they set (so that facilities are not faced with an immediate compliance deadline as soon as they exit RECLAIM).

To help facilitate the identification of which facilities fit into these categories, Staff is also proposing amendments to District Rule 2002 to provide for notification procedures for the to be transitioned facilities.

III. THE DISPOSITION OF RECLAIM TRADING CREDITS AFTER A RECLAIM EXIT: RULE 2002 AMENDMENTS

The District is also preparing to amend Rule 2002, covering, among other things, RTC allocation methodology, in January 2018. In its November 2017 "Preliminary Draft Rule 2002", the District is proposing to provide notification to the individual RECLAIM facilities that the facility is being reviewed for being transitioned out of RECLAIM and requiring the facilitate to identify all NOx RECLAIM emission equipment at the facility. Based on the information, the District will review and determine whether or not the facility will be transitioned out in the near term or down the road. If the District determines that a facility will be transitioned out, under the current draft of the amendment rule, that facility will be prohibited from selling any future compliance years RTCs and may only sell currently compliance year RTCs until the facility is transitioned out of the RECLAIM Program.[4] This proposal is certain to raise concerns among RTC holders. Many facilities have spent significant amounts of money to reduce emissions, or to purchase RTCs. There is concern among these facilities that the District's proposal to confiscate RTCs is not appropriate, and possibly not legal. RTC allocations were based on actual emissions for facilities, which were in turn based on permits issued to facilities that created vested rights to emit. Prior to RECLAIM, facilities provided emission reduction credits to obtain their permits and establish their rights to emit at that level. Fees were paid every year on the emissions. Allocations were created based on something that already existed—a vested right to emit under a permit.

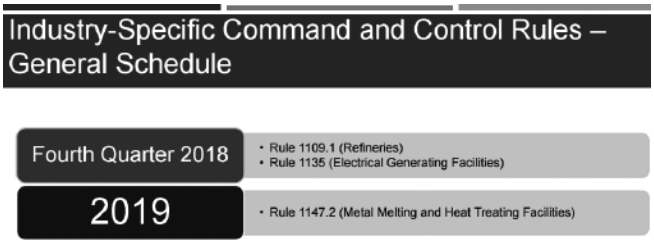
The California Court of Appeal for the Third District ruled earlier in 2017, in a case addressing emissions credits under California's greenhouse gas cap and trade program, that "emissions allowances consist of valuable, tradeable, private property rights." (*Cal. Chamber of Commerce v. State Air Resources Bd.*, No. C075930 (Cal. Ct. App. Apr. 6, 2017).) The court further stated that "an emissions allowance conveys a valuable property interest—the privilege to pollute California's air—that may be freely sold or traded on the secondary market." It remains to be seen whether the District's efforts to transition RECLAIM will face similar challenges from RTC holders. Written comments on the proposed amendments are due November 22, 2017.

IV. NEW COMMAND AND CONTROL RULES POST-RECLAIM AND OTHER POTENTIAL TRANSITION MECHANISMS

The District is currently exploring a number of potential RECLAIM transition mechanisms including source specific command and control rules and industry-specific command and control rules. In looking at source-specific command and control rules, the District has indicated

that it intends to both amend existing rules and develop new rules and has proposed the following schedule:[5]

Looking at potential industry-specific command and control rules, the District has indicated that it will develop rules for refineries and electrical generating facilities and that is considering other industry categories such as metal melting and heat treating facilities and has offered the following schedule for such rules:



The District has further indicated that a RECLAIM transition rule "may be needed to establish the implementation schedule for facilities with multiple pieces of equipment." While the District has expressed a preference to use source-specific, industry-specific and RECLAIM transition rules before utilizing individual compliance plans, it has recognized that a compliance plan may be needed to address unique operations or equipment. The compliance plan would include a facility-specific compliance schedule and emission limits.

The timing of adoption of these rules is driven in part by the passage of AB 617 last summer. AB 617 was adopted as a companion to the bill extending California's greenhouse gas cap and trade program through 2030 (AB 398) and increases the pressure on the District to update its rules so that facilities, including many current RECLAIM facilities, are at BARCT. AB 617 requires that each air district in a nonattainment area adopt by January 1, 2019, an expedited schedule for the implementation of BARCT "by the earliest feasible date, but in any event not later than December 31, 2023."[6] This implementation schedule applies to each facility that, as of January 1, 2017, was subject to the state's greenhouse gas cap and trade program. Further, AB 617 requires that BARCT implementation must "give highest priority to those permitted units that have not modified emissions-related permit conditions for the greatest period of time."[7]

V. NEW SOURCE REVIEW POST-RECLAIM

New Source Review ("NSR") is conducted to ensure best available control technology ("BACT") is applied to every emissions source at a new, relocated, or modified facility. Permits authorizing construction of new facilities, or relocation or modification of existing facilities, cannot be issued absent NSR.

A. RECLAIM NSR

Under RECLAIM, all new or relocated facilities must demonstrate use of BACT, as well as compliance with modeling requirements. Prior to commencing operations, new and relocated facilities are required to acquire RTCs at a one to one ratio to cover all emissions associated with the sources' first year of operations. (After the first year, the facility is treated in the same manner as existing facilities and must hold sufficient RTCs to cover emissions as of the end of each reconciliation period for each compliance quarter.)

Modifications to existing RECLAIM facilities, which result in an emissions increase (based upon a comparison of post-modification to pre-modification potential to emit) are also subject to BACT and modeling requirements. In addition, such facilities must demonstrate that the emissions increase can be offset through internal netting or that sufficient RTCs have been acquired to account for any net increase in emissions.

B. Post-RECLAIM NSR

Upon exiting RECLAIM, facilities will face NSR requirements under District Regulation XIII. It is broadly similar to RECLAIM with a couple important changes. First, any emissions increase must be offset at a 1.2:1 ratio (as opposed to RECLAIM's 1:1 ratio). Second the emissions increase must be offset with emission reduction credits ("ERCs") as opposed to RTCs.

Although the District Staff has expressed in RECLAIM working group meetings that it does not want the ERC supply to inhibit growth and facility modernization, Staff admits that it is still struggling with how to achieve this goal.

Staff has taken the position that RTCs cannot be converted into ERCs (despite the fact that 6.8 tons of ERCs were converted into RTCs when facilities entered RECLAIM in 1994). Further, the Staff is proposing that equipment permitted pre-RECLAIM and then shut down during the time a facility is in RECLAIM will not create a post-shutdown ERC for that facility (even though the facility could have generated an ERC if it had never entered RECLAIM).

Given the lack of NOx ERCs available on the open market, Staff has floated the idea of making its internal bank cache of NOx RTCs (approximately 22 tpd)

available to post-RECLAIM facilities. However, US EPA has reportedly expressed concerns about this approach.

VI. THE LONG ROAD AHEAD

The end of RECLAIM will mean less flexibility for large emitters in meeting emissions targets. Moreover, the District is in the process of ratcheting down District-wide emissions goals to meet recently-revised and ever stricter National Ambient Air Quality Standards promulgated by US EPA, new requirements applicable to stationary sources pursuant to state law AB 617, and the aggressive goals in the 2016 AQMP the District passed earlier this year. The combination of more stringent emissions standards and less flexibility in meeting them has made the RECLAIM transition a subject of great interest and concern among RECLAIM facilities, as well as the other facilities that will be impacted by the many new District rules that will be adopted as result of the RECLAIM transition. There is great risk, uncertainty and opportunity—and not much time to spare—as the District quickly charges ahead into a brave new post-RECLAIM and AB 617 world. Managing the RECLAIM transition is likely to be a long and complex journey for all stakeholders, and it will be of paramount importance for these stakeholders to provide prompt input during the transition process.

ENDNOTES

1. Over the years, the District has performed a number of BARCT equivalency analyses for the RECLAIM program The first BARCT equivalency analysis was completed by SCAQMD staff in 2004 in connection with the 2003 AQMP. The BARCT equivalency analysis resulted in a set of amendments passed in January 2005 which reduced the NOx emissions target by 7.7 tons per day ("tpd"). The 2005 amendments reduced the supply of RTC holdings by approximately 22.5 percent. The 2005 reduction was implemented in five phases: A 4 tpd reduction was required by 2007 and an additional 0.925 tpd reduction was required in each of the four subsequent years. These reductions were fully phased in by the 2011 RECLAIM compliance year. The 2012 AQMP included a measure calling for up to a 5 tpd shave. However, following a BARCT equivalency process, the SCAQMD Governing Board ultimately approved in December 2015 a NOx RECLAIM shave of 12 tpd—a 45% reduction in the market—to be implemented by compliance year 2022. The reduction is being phased in as follows: a 2 tpd reduction in each of compliance years 2016 and 2017, increasing to 3 tpd in compliance year 2018, 4 tpd in compliance year 2019, 6 tpd in compliance year 2020, 8 tpd in compliance year 2021 and 12 tpd in compliance year 2022 and thereafter. The District implemented a SOx RECLAIM shave in 2010.

2. Facilities subject to the RECLAIM program receive an allocation of RTCs at the beginning of each compliance year. Facility allocations were initially determined based upon historic production levels and current or projected rule requirements during the years 1994, 2000 and 2003. NOx RTC allocations for 2004, 2005 and 2006 and SOx RTC allocations for 2004 through 2012 were equal to each facility's 2003 allocations. Declining annual "adjustment factors" successively reduced NOx RTC allocations for each year subsequent to 2006 and SOx RTC allocations for each year subsequent to 2012.

3. Sources: Analysis of data from SCAQMD. "RECLAIM Sources" data is reported (audited) emissions from SCAQMD RECLAIM Audit Report (March 2015). "Stationary Sources (Non-RECLAIM)" and "Mobile Sources" is taken from SCAQMD Air Quality Management Plans (1997, 2003, 2007, 2012) and AQMP Working Group Meeting #5, Agenda Item #3.

4. The RECLAIM program divides facilities into two compliance cycles. Cycle I facilities receive annual allocations applicable to emissions from January 1 to December 31 of each calendar year. Cycle II facilities receive annual allocations applicable to emissions from July 1 of one year to June 30 of the next year. Facilities may purchase and use RTCs issued for the other overlapping compliance cycle so long as they cover emissions that occur prior to the RTCs' expiration.

5. *See* November 8, 2017 NOx RECLAIM Working Group Meeting Presentation, available online at http://www4.aqmd.gov/enewsletterpro/uploadedimages/000001/Jennifer/RECLAIM/RECLAIM%20WGM-110817.pdf.

6. AB 617 also requires the California Air Resources Board (ARB) to prepare a community monitoring plan for disadvantaged communities, identifying those with "high exposure burdens" for criteria pollutants and air toxics. ARB must also: (i) prepare a statewide emission-reduction strategy (and update it every 5 years); and (ii) select communities to implement emission-reduction programs. An individual facility could be required to reduce emissions "commensurate with its relative contribution" if it contributes to a material impact on a disadvantaged community.

7. AB 617 provides flexibility to allow alternative BARCT, emissions trading-based compliance or "equivalent emissions reductions" at a lower cost, and units with new or modified permits issued post-2007 are exempt from the BARCT implementation requirement.