A. Regulatory and Contractual Liability in the Open Market

Currently, most emissions trades between existing sources are made through single-source SIP revisions that must be approved by both States and EPA. Pre-approval scrutiny of each trade is generally effective in ensuring that trading does not interfere with air quality requirements: For example, that the emission reductions and increases involved are calculated from appropriate baselines and are appropriately quantified. However, individual SIP revisions take considerable time and involve substantial costs for both the private sector and State and Federal governments. At least in part because of these transaction costs, the number of emissions trades between existing sources has been relatively low, and significant potential opportunities to meet air quality objectives at lower cost have not been realized.

The EPA's fundamental objectives in this proposal are to free up the market for a higher volume of cost-effective emissions trading while at the same time maintaining the relatively high level of quality assurance that the current system provides. To meet these objectives, EPA has used the following ''design criteria'' in designing the proposed open market trading rule. The proposed rule should:

(1) Support timely attainment and maintenance of the Clean Air Act's public health protection standards;

(2) Reduce private sector compliance costs, making it possible to better protect the environment at lower cost;

(3) Reduce governmental costs in administering an expanded emissions trading system;

(4) Make maximum use of private sector mechanisms for quality assurance (liability arrangements, contractual guarantees, insurance, third party services, etc.);

(5) Give potential market participants the ability to predict with reasonable certainty which emission reduction actions will be found valid and creditable by governmental authorities; and

(6) Provide the private sector with strong incentives to comply with all requirements while at the same time giving responsible (''good faith'') market participants reasonable expectations on potential exposure to civil or criminal penalties.

The proposed rule, as already noted, is derived from the ''open market'' concept developed by the EPA-supported NESCAUM-MARAMA demonstration project and elaborated in a recent article.[2] This approach avoids the need for single-source SIP revisions by treating emissions trading as a compliance option, that is, as another means of compliance with applicable pollution control requirements contained in the State Implementation Plan (SIP).

At present, most SIP's establish emission limitations directly applicable to specific equipment and operations at facilities. Owners and operators of such facilities must comply with these emission limitations by installing emissions control equipment, making process changes, or changing fuels or other inputs. Failure to comply is a violation of State law and section 113 of the Clean Air Act and exposes the source to enforcement proceedings by the State and EPA. Citizens may also bring actions to enforce these obligations under section 304 of the Act.

Under the open market concept, sources would have the option of complying by purchasing appropriate amounts (tons) of discrete emission reductions (DER's) generated by others. The governmental role in reviewing emissions trades would be transformed from prior approval during SIP revisions to ''post-hoc'' scrutiny during compliance determinations. Eliminating pre-approval of reductions and shifting to review at the compliance stage would greatly free up the market and increase trading volume, thereby reducing compliance costs and benefitting the environment.

A key issue identified, however, in the NESCAUM-MARAMA demonstration project and in the above-cited article is how to maintain confidence that DER quality will remain high—that reductions will be taken only from appropriate baselines and rigorously quantified—as government involvement moves from prior approval to compliance auditing.

Maintaining confidence in the quality of DER's is critical from all perspectives. Regulatory authorities and the public need to know that pollution will actually be reduced as projected, and the private sector needs to know that the market will reward high quality reductions and reject defective ones. Yet detailed compliance audits are inherently conducted on only a fraction of sources each year, as limited governmental enforcement resources must be targeted at a range of high priority environmental problems.

In the stakeholder and interagency review processes conducted prior to this proposal, a number of options were put forward for maintaining DER quality assurance in an expanded emissions trading market. The proposal made today is a hybrid of these options that EPA has developed using the ''design criteria'' described above. The EPA believes this hybrid best serves the twin objectives of freeing up the market for a higher volume of emissions trading while maintaining sound quality assurance incentives.

1. Option 1: User Liability

The first option considered was put forth by the original developers of the open market concept. Building directly on the current regulatory structure, they contemplated that liability for deficiencies in DER's under the Clean Air Act and State air pollution laws would remain with the party who purchased and used the DER's as a compliance option, since that party had the original compliance obligation. The key concepts underlying this option are that (1) DER's are compliance products similar to pollution control equipment, and (2) as such the user source is responsible for compliance when using DER's just as it is when complying by use of control equipment.

Like sources using purchased control equipment or services, sources using DER's to meet their emission limits would be able to control their compliance risks by choosing carefully among vendors and by negotiating for appropriate guarantees, insurance, or indemnification provisions. Pollution control equipment and services purchased from vendors generally come with guarantees specified in contracts or implied under commercial law, or with specific insurance policies or indemnification agreements as negotiated by the parties. Pollution sources using purchased control equipment or services, however, remain responsible for their own compliance obligations with State and Federal pollution laws, and remain liable to enforcement authorities in cases of non-compliance, even if the non-compliance was caused by a shortcoming in the products or services purchased from a vendor. In that case, sources have recourse to contractual guarantees, insurance, or indemnification provisions. Through these provisions sources can return to compliance (e.g., obtain satisfactory equipment) and be compensated appropriately for damages.

Liability for compliance with State and Federal pollution laws and the

[2] Emissions Reduction Credit Demonstration Project, Phase II, Volume I Final Report, April 1995. Developing a Market in Emission Credits Incremental: An ''Open Market'' Paradigm for Market-Based Pollution Control; Richard Ayres, Bureau of National Affairs Environment Reporter, Current Affairs December 2, 1994.