Agenda Item C – Cost Containment

Meeting #5 – April 12th, 2017

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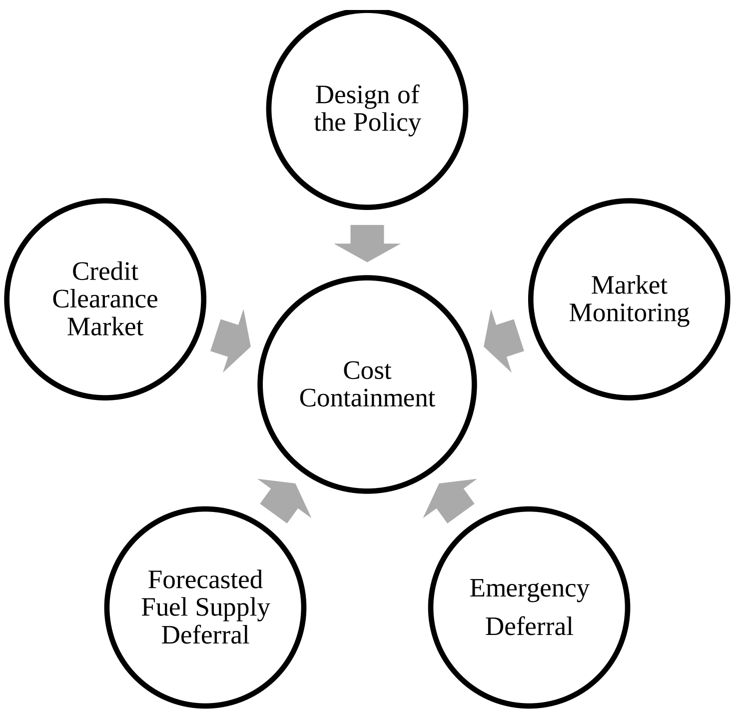
As stated in the charter, the Clean Fuels Program (CFP or program) 2017 rulemaking advisory committee was asked to provide input on the need for additional cost containment measures in the program and the design of those measures if they are needed. The work of the committee has been thorough, thoughtful and constructive and DEQ greatly appreciates the time committee members have invested in this process.

This paper presents DEQ's initial recommendations for a comprehensive and robust approach to cost containment for the CFP. DEQ's proposals below are informed by our committee discussions.

Following are five elements of the CFP that will work together to contain the cost of the program:



Design of the Policy

As a market-driven mechanism for lowering the carbon-intensity of transportation fuels, the design of the CFP has a number of inherent features that lower costs for regulated parties and consumers compared to a command-and-control regulation. Following are several such features that currently exist in the CFP:

- **Annual compliance period**: allows companies to show compliance with the standards on an annual basis rather than gallon-by-gallon or month-by-month.
- **Fuel and technology-neutral**: The program grades all fuels on their carbon-intensity and creates a level playing field for fuels to compete and improve their carbon-intensity performance.
- **Gradual progression to program goal**: The reduction in carbon-intensity begins modestly (0.25% in 2016) and progresses annually toward the program goal (10% reduction in 2025). This allows fuel producers time to identify the most cost-effective strategies to achieve this long-term target.
- **Credits can be traded**: Tradeable credits lower compliance costs by allowing companies that can more efficiently exceed the standards of the program to do so and sell surplus credits to businesses that are not able to as cost effectively create their own credits.
- **Banking credits**: Allowing companies to store surplus credits between compliance periods reduces costs in later years when there are more stringent requirements.
- **Credits work uniformly for gasoline and diesel**: Credits generated from any fuel type can be used to offset deficits generated from any other fuel type. For example, credits created through the use of biodiesel in diesel blends can be used to comply with the clean fuels standard for gasoline. This encourages the cheapest sources of carbon-intensity reductions to be found and fully utilized.
- **Carry over deficits**: The program also has a small deficit carry-over, which allows firms to carry a small deficit (less than 10%) over to the next compliance period.

Collectively, these program design measures provide compliance flexibility that should yield more cost effective achievement of the program goals than a design with fewer methods for compliance.

Market Monitoring

DEQ recognizes as with any new commodity, environmental or otherwise, that the CFP credit market may experience some swings in credit prices in its early stages as market participants learn how to price their credits. Committee members asked whether the program should add a feature to monitor and react to short-term movement in credit prices. This prompted a productive discussion about the pros and cons of this concept.

DEQ appreciates concerns that credit prices may be volatile in the beginning stages of the program and the effort of committee members to design and consider potential short-term mechanisms. DEQ is not currently proposing to adopt such a mechanism. Other mechanisms described below, especially the proposed additions to the Emergency Deferral could address some of these concerns while allowing the market to develop on its own. As trading increases and credit prices fluctuate, DEQ can reassess if a short-term mechanism is needed.

This section is intended to focus on the on-going monitoring the of the clean fuels credit market, including trends in credit/deficit generation and trades. The program already has several monitoring features in place, including:

- Quarterly reporting of fuel transactions and calculation of deficit and credit balances. This allows early tracking of compliance needs and allows DEQ to provide early technical assistance if needed.
- Transfer-specific price and volume reporting
- Recordkeeping and inspection requirements

DEQ is proposing to add several new provisions through this rulemaking to clarify:

- That the current recordkeeping requirements apply to the documents and other materials underlying credit transfers.
- What is considered prohibited conduct within the clean fuels credit market.
- How DEQ will take action against bad actors or bad credits.
- What DEQ's authority is to suspend, revoke, or modify fraudulent credit trades.

Recordkeeping requirements

As discussed in a previous paper, DEQ is proposing to clarify its current recordkeeping and inspection requirements to ensure that they clearly apply to credit transfers. DEQ believes that its current record-keeping and inspection requirements extend to documents underlying credit market transfers, as they are necessary for the calculations to determine compliance.

The clarification here is meant to communicate clearly to regulated parties and market participants that DEQ, as part of its market monitoring efforts, is requiring credit transaction forms and supporting documents to be kept for the specified period and be available for review. This could be as part of a broad, general review of the market or because DEQ has questions about a specific transfer or series of transfers.

DEQ is proposing following draft rule language for its straw proposal, in a redline from the current rule:

OAR 340-253-0600 Records

(1) Records Retention. Regulated parties, credit generators and ~~brokers~~ aggregators must retain the following records for at least 5 years:

(a) Product transfer documents as described in section (2);

(b) Records related to obtaining a carbon intensity described in OAR 340-253-0450;

(c) Copies of all data and reports submitted to DEQ;

(d) Records related to each fuel transaction;

(e) Records related to each credit transaction; and

(~~e~~f) Records used for compliance or credit calculations.

(2) Documenting Fuel Transactions. A product transfer document for transactions above the rack, or transactions below the rack where obligation is being passed on, must prominently state the information specified below.

(a) Transferor company name, address and contact information;

(b) Recipient company name, address and contact information;

(c) Transaction date;

(d) Fuel pathway code;

(e) Carbon intensity;

(f) Volume/amount;

(g) A statement identifying whether the transferor or the recipient has the compliance obligation; and

(h) The EPA fuel production company ID and facility ID as registered with the RFS program.

(3) Review. All data, records, and calculations used by a regulated party, a credit generator or an aggregator ~~broker~~ to comply with the Oregon Clean Fuels Program or transfer credits within the program's market are subject to verification by DEQ. Regulated parties, credit generators and brokers must provide records retained under section (1) within 60 calendar days after the date DEQ requests a review of the records, unless DEQ specifies otherwise.

Prohibited conduct

DEQ is proposing to list in the rule prohibited conduct while trading in the program's credit market:

- Fraud, or an attempt to defraud or deceive using any device, scheme or artifice; or
- Either party employed any unconscionable tactic in connection with the transfer; or
- Any false report, record, or untrue statement of material fact or omission of a material fact related to the transfer or conditions that would relate to the price of the credits being transferred. A fact is material if it is reasonably likely to influence a decision by a counterparty or by the agency; or
- Where the intended effect of the activity is to lessen competition or tend to create a monopoly, or to injure, destroy or prevent competition; or
- A conspiracy in restraint of trade or commerce; or
- An attempt to monopolize, or combine or conspire with any other person or persons, to monopolize.

These activities are already generally prohibited under Oregon law under various statues. Adding these prohibitions in the CFP rules would also make these activities an enforceable violation of this program.

DEQ action

In the event of any of the activities in the prior section coming to pass, the following authority could be used in addition to any formal enforcement action taken by the agency. The authority to suspend, revoke, and modify is an additional tool, and not meant to take the place of any civil or criminal enforcement processes undertaken by DEQ or the Oregon Department of Justice. The proposed new provisions serve as an additional safeguard of the integrity of the credit market.

The authority may also be used to ensure that errors in quarterly reports or carbon-intensity scores are corrected if they are determined to be in significant error, and the reporting party or fuel producer in question does not voluntarily act to correct their reports or carbon-intensity score.

Authority to suspend, revoke, and modify

DEQ is proposing to add text to the registration and quarterly report submittals that informs regulated parties that any credits or deficits generated as a result of their participation in the program is subject DEQ's authority. The regular text is what currently appears in the CFP Online System, the online reporting tool, and the bold text is the proposed additions:

> "I, [Name of real person], as person with Signatory Authority, am submitting this report on behalf of [Company Name], with the understanding that the information contained in this report is considered an official submission to Oregon Department of Environmental Quality for purposes of compliance with the Clean Fuels Program (CFP) regulation.
>
> Furthermore, by submitting this report, I understand that I am bound by, and authenticate this record, and attest to the statements contained within. I also understand that submitting or attesting to false statements may constitute a serious crime, punishable under the Oregon Penal Code, or other criminal offenses punishable under state, municipal, or federal law. I certify that information supplied herein is correct and that I have the authority by the company identified herein to submit this report.
>
> **As a condition of participating in the program, I acknowledge that credits are regulatory instruments that do not constitute personal property, instruments, securities or any other form of property, per OAR 340-253-1050(1)(a). Credits and deficit calculations are subject to the provisions of the [Authority to Suspend, Revoke, and Modify OAR], which DEQ may use to correct errors should a regulated party or credit generator not do so themselves, place holds on credits and/or accounts as part of an inquiry, and invalidate credits or fuel pathway codes that were illegitimately generated or otherwise created in error. Credits and accounts may be placed on hold while an inquiry is underway. Suspension, revocation, and/or modification actions may be contested pursuant to ORS Chapter 183, OAR Chapter 340, Division 011 and OAR 137-003-0501 to 0700."**

DEQ is still working on the straw proposal regulatory text for the authority to suspend, revoke, and modify internally, and plans to issue that text ahead of our next Advisory Committee meeting in May.

Emergency Deferral

The program currently has an Emergency Clean Fuel Supply Deferral mechanism that is meant to deal with a situation where there is a widespread, short-lived and unanticipated disruption in the supply of clean fuels such that regulated parties cannot comply with the program. This mechanism would be triggered in the event of a shortage caused by a natural disaster or another disruption in the production and transportation of clean fuels that would cause a credit shortfall that is more than 5% of the total credits generated in the prior year.

<u>DEQ is proposing</u> to expand this mechanism into a more general deferral that addresses a broader set of short-term situations. This mechanism would allow the agency to take quick action to protect consumers in the unlikely event that the program or its credit market becomes temporarily disrupted or risks imposing undue burdens on consumers and regulated parties, and is being proposed largely in response to the concerns about short-term market issues discussed in the previous section.

The proposed language is:

- There is a disruption to the program or its credit market such that it will or is creating undue burdens on regulated parties and Oregon fuel consumers. In determining the magnitude of the disruption and its effects, DEQ will consider the following:
    - The root cause and the likely duration of the disruption;
    - The effect of the disruption on retail fuel prices;
    - The effect on retail availability of transportation fuels;
    - The effect to the program of issuing the deferral;

DEQ is also considering the pros and cons of setting more specific triggers for specific situations, being especially mindful that specificity in the regulation might limit the agency's ability to respond to real world situations without unintended consequences. DEQ is also mindful that having triggers that are so prescriptive might lead to a situation where DEQ believes an emergency deferral should not be triggered. DEQ is asking for input on examples of specific situations where specific triggers are needed and action would be necessary to address them.

<u>DEQ is also proposing</u> the following mitigation options be available to the agency if the emergency deferral is triggered:

(b) If DEQ determines under section (1)(c) that it must issue a deferral, then DEQ will determine:

(A) The start date and end date of the emergency deferral period, which may not exceed one year, but which may be renewed if DEQ makes a subsequent determination under section (1);

(B) Which of the following methods will be used to defer compliance with the clean fuel standard:

(i) Suspend the ability to transfer credits, except as part of the operation of a normal-called or an emergency credit clearance market;
(ii) Allowing deficits to be carried over into future compliance periods, notwithstanding OAR 340-253-1030(4) through (6);
(iii) Suspend deficit accrual during the emergency deferral period; or
(iv) Call an emergency Credit Clearance Market following the procedures under OAR 340-253-**XXXX**, except that for an emergency clearance market;
    (I) The agency will set and publicly notice new dates for the various steps in the Emergency Clearance Market. At that time it may also set a new maximum credit price and include it in that notice;
    (II) DEQ may choose to waive the pro-rata calculations in the credit clearance market; and
    (III) If the emergency Clearance Market will conclude prior to the due date for Annual Reports, the deficit role-over provisions of the Credit Clearance Market under 340-253-**XXXX**(1) will be suspended.

The intent of these mitigation options is to give DEQ the ability to tailor its response to the particular situation which would cause the agency to invoke the emergency deferral. The agency welcomes any additional suggestions for possible mitigation options.

Forecasted Fuel Supply Deferral

DEQ believes that the Forecasted Fuel Supply Deferral mechanism is its primary tool to ensure that the program remains achievable on a short-term basis (year-to-year). A strong supply of clean fuels leads to a strong supply of credits and least-cost options for regulated parties.

Under the existing rules the agency conducts a forecast to determine whether the supply of clean fuel credits are sufficient to compliance with next year's standard. If the forecast suggests there will be an inadequate supply of lower carbon fuels in the next year, DEQ would evaluate the significance of the shortage based on its impact to the regulated parties' ability to meet their compliance obligations. The regulation currently defines an inadequate supply as being more than 5% of the anticipated compliance obligations, both in terms of the volume of lower carbon fuels and the credit generation potential from those fuels based on their carbon intensity.

The regulation goes on to require the agency to determine whether implementing a mitigation strategy will remedy the shortage. In some cases, the shortage could be temporary in nature and warrant a temporary strategy such as a temporary suspension in deficit generation until the fuel supply problem is resolved. In other cases, the shortage could be more enduring and DEQ might consider a longer-term strategy such as modifying the annual compliance requirement.

As presented in previous advisory committee meetings, ICF International conducted the 2017 forecast for DEQ which showed adequate supply of credits to comply with this year's standards. In addition, ICF International will assist the agency in developing a tool that the agency will use to conduct future supply forecasts.

Credit Clearance Market

DEQ is proposing to adopt a Credit Clearance Market (CCM) mechanism to place a cap on credit prices in the CFP's market. A CCM provides regulated parties an opportunity to purchase credits at an inflation-adjusted credit price ceiling from other market participants to make up credit shortfalls. Entities that are unable to obtain credits needed for compliance during the credit clearance event would be able to "carry over" deficits.

This is the mechanism that California has implemented in their LCFS, and DEQ notes strong stakeholder consensus within our committee that this is also the right option for Oregon. The benefits of a Credit Clearance Market include:

- Maintains the environmental integrity of the program by not creating credits with no actual emission reduction or having regulated parties pay their way out of compliance.
- Ensures that there is a clear and predictable path to compliance for regulated parties even if there is a shortfall in the total supply of credits.
- Maintains the policy incentive to supply low-carbon fuels to Oregonians.
- Mirroring the California mechanism provides a consistent regional low-carbon fuel policy framework.
- Gives regulated parties and credit generators one last chance to monetize any credits they have left at the end of a compliance period.
- Provides policy certainty and stability to the market and to investors in low-carbon fuels.
- Provides a level playing field for regulated parties.

DEQ is proposing that the Credit Clearance Market's maximum price be adjusted for inflation, and be set at $250 for the potential Credit Clearance Markets covering the 2016-2023 compliance periods, and $200 for the 2024-2025 compliance periods. DEQ notes that in the proposed text the prices are set for the years in which those Credit Clearance Markets will operate, which is the year following the annual compliance period.

DEQ believes that this tiered cap appropriately balances the legislature's mandate for a 10% reduction in the carbon-intensity of the state's transportation fuels with the direction in SB 324 to "adopt by rule provisions for managing and containing the costs of compliance with the standards." DEQ is proposing this tiered cap because:

- A higher cap in the earlier years of the program should provide pricing flexibility to the market that encourages greater investments in infrastructure to deliver low-carbon fuels, and thereby lowering credit prices in the later years of the program.
- The structure of the program is such that higher credit prices have less effect on retail prices earlier in the program than they do in the program's last two years.
- A higher cap in the earlier years gives pricing flexibility for Oregon's market to compete with regional jurisdictions (such as California and British Columbia) that also have policies designed to increase low carbon fuels.
- Oregon's Clean Fuels Program does not have many of the complementary policies and grant programs that support California's LCFS.

There are two areas that DEQ is asking for additional input:

- With respect to the small deficit carry-over, should it be maintained at 10% or lowered to 5%?
- With respect to charging interest on carried-over deficits from the CCM,
  - For importers of finished fuel suppliers, interest will not be charged
  - For everyone else, interest will be charged at an annual rate of 5% or the last 12 months of the consumer price index.

<u>DEQ is proposing</u> the following draft rule language for its straw proposal:

OAR 340-253-2300 Credit Clearance Market

(1) If a regulated party did not retire sufficient credits to meet its compliance obligation under OAR 340-253-1030, exclusive of any deficits carried forward to the next compliance period under 1030 (4), it must enter and purchase its pro-rata share of credits in the Clearance Market if one occurs.

(a) The Clearance Market is separate from the normal year-round market for Credits in the Clean Fuels Program.

(b) A regulated party that fails to comply under OAR 340-243-1030 is still in compliance with the rules if they:

(A) Acquire their Pro-Rata Obligation in the Clearance Market and retires that number of credits within 30 days of the end of the Clearance Market; and

(B) Retires any remaining balance of its annual obligation, which will increase at [5% per year **OR** with the same rate of inflation as specified in section (3) per year], within five years.

(C) If no Clearance Market occurs, DEQ will record any regulated party's unmet compliance obligation in that regulated party's Accumulated Deficits account, and the regulated party will be deemed in compliance for that year, so long as it retires that Accumulated Deficit balance, [with interest as in (B) above], within five years.

(2) The maximum price for the credit clearance market will be set as follows:

(a) $250/t in 2018-2024;

(b) $200/t in 2025 and thereafter;

With the above numbers adjusted annually for inflation at the end of each January by DEQ using the inflation rate as provided by the last twelve months of data from the US Bureau of Labor Statistics 'CPI-U, US City Average, All Items, Not Seasonally Adjusted, 12 Month Percent Change' series. The formula for that adjustment is as follows: Maximum Price = [Last year's Maximum Price] * (1 + [CPI-U]). DEQ will publish a notice of the new maximum price on its website each year once it has been calculated.

(3) Acquisition of Credits in the Clearance Market. The Clearance Market will operate from June 1st to July 31st if needed.

(a) Regulated parties subject to section (1) must acquire their pro-rata share of the credits in the clearance market while it is active.

(b) Credits acquired in the Clearance Market can only be used for the purposes of retiring them against their compliance obligation from the prior year.

(c) To qualify for compliance through the Credit Clearance Market, the regulated party in question must have:
   (A) Retired all credits in their possession; and
   (B) Have an unmet compliance obligation for the prior year that has been reported to DEQ through their annual report.

(4) Selling Credits in the Clearance Market. On the first Monday in April, DEQ shall issue a call to all parties in the CFP Online System to pledge credits into the Clearance Market. Parties wishing to pledge credits into the Clearance Market will indicate to DEQ that they wish to do so through their annual report on or before April 30th.
   (a) DEQ will announce if a Clearance Market will occur by May 15th of each year.
   (b) In order to participate in the Clearance Market, sellers must:
      (A) Agree to sell their credits at or below the maximum price set out in section (2) for that year by July 31st;
      (B) Agree to withhold any pledged credits from sale in the normal year-round credit market until the end of the Clearance Market on July 31st, or if no Clearance Market is held in a given year, then on the date which DEQ announces it will not be held;
      (C) Parties that pledge credits into the Clearance Market cannot reject an offer to purchase the credits at the maximum price for that year, unless they have already sold or agreed to sell those pledged credits.

(5) Operation of the Clearance Market. DEQ will inform each regulated party that failed to meet their Annual Compliance obligation under OAR 340-253-1030 of their pro-rata share of the credits pledged into the Clearance Market.
   (a) Calculation of pro-rata shares. Each regulated party's pro-rata share of the credits pledged into the Clearance Market will be calculated by the following formula:

   Regulated Party A's pro-rata share =

$$\left[\frac{A's\ total\ deficit}{All\ parties'\ total\ defficts}\right] x\ [the\ lesser\ of\ (pledged\ credits)\ or\ (total\ deficits)]$$

   Where: Total deficit refers to the regulated party's total obligation for the prior compliance year that has not been met under OAR 340-253-1030; all parties' total deficit refers to the sum of all of the unmet compliance obligations for regulated parties in the Clearance Market; and pledged credits refers to the sum of all credits pledged for sale into the Clearance Market.
   (b) On or before June 1st, DEQ will post the following information to the program's website:
      (A) The name of each party that did not meet the requirement;
      (B) The name of each party that has pledged credits for sale, and how many credits they pledged.
   (c) Following the close of the credit market, regulated parties which purchased credits in the Clearance Market must submit to DEQ an amended Annual Compliance Report by August 31st which shows the acquisition and retirement of their pro-rata share of credits in the Clearance Market, and any remaining deficits carried over.
   (d) If a regulated party has unmet deficits after acquiring and retiring credits in the Credit Clearance Market, DEQ shall record the remaining unmet deficits from that compliance year into that regulated party's Accumulated Deficit account.

(6) Regulated parties that have deficits in their Accumulated Deficit account will be charged interest annually in the form of additional deficits. Each May 1st DEQ will charge the interest rate under section (1)(b)(B) to the number of deficits remaining in the Accumulated Deficit account following the submission of the Annual Reports.
   (a) Regulated parties must repay all Accumulated Deficits within five years of the end of the compliance period in which any such deficit occurred.
   (b) Regulated parties may repay unmet deficits during any subsequent annual report before the end of the five years in (a), so long as they have fully met their compliance obligation for that year and are not carrying forward deficits under OAR 340-253-1030(4).
   (c) Regulated Parties that have an Accumulated Deficit cannot transfer or sell credits to another regulated party through the normal year-round credit market or through a subsequent Clearance Market.

Comments

The agency invites comments addressing all aspects of this paper. This discussion will be captured in the meeting summary and posted on the committee webpage. DEQ will accept written comments for two weeks after the meeting in order to develop materials for the next meeting. Comments received after two weeks will still be considered, but may not be reflected in the next meeting's materials. Please e-mail any written comments to: OregonCleanFuels@deq.state.or.us.