

## Technical Workshop: Cost Containment

**Design elements that provide flexibility to regulated entities in complying with the greenhouse gas emissions cap and reduce program**

**Meeting Date: Sept. 15, 2020**



State of Oregon  
Department of  
Environmental  
Quality

### Workshop attendance

Participants interested in engaging in a technical discussion of program design elements, mechanisms, options and implications to cap and reduce greenhouse gas emissions within the Oregon Environmental Quality Commission's existing legal authority are encouraged to attend. Workshop participants are encouraged to provide input and ideas, be constructive and creative, and to work toward solutions.

**Please note that program design decisions will not be made during workshops. The EQC will make decisions when it meets to consider the proposed rules.**

Those seeking to participate in broader conversations about DEQ's efforts to cap and reduce greenhouse gas emissions and to provide more general comments may want to attend the public meetings to be held this October in a town hall format.

### Background

On March 10, 2020, Gov. Kate Brown signed Executive Order 20-04, directing state agencies to take actions to reduce greenhouse gas emissions and respond to climate change in agency planning. The order contains several directives for the EQC and DEQ to take action consistent with existing legal authority to reduce emissions toward meeting the science-based reduction goals separately established in the order. One of the specific directives is for the EQC and DEQ to cap and reduce emissions from large stationary sources, transportation fuels, and liquid and gaseous fuels.

Those sources of emissions do not constitute all statewide sources of greenhouse gas emissions. The cap and reduce programs will support reducing emissions from some of the most significant sources in Oregon, but it is only one element of multiple reinforcing policies and actions across state agencies that will be necessary to achieve statewide reduction goals. Actions in other programs may reduce compliance obligations for regulated entities under cap and reduce programs.

This workshop is part of DEQ's effort to meet this directive. Prior to opening a formal rulemaking, DEQ will host a series of topic-specific workshops and public meetings to receive input and help inform the program design.

### Workshop topic Introduction

DEQ is developing a cap and reduce program to reduce greenhouse gas emissions across multiple economic sectors. This may be done through a market-based program which more cost-effectively reduces emissions as compared to a direct command and control regulation. There are many aspects of market-based program design that help

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lower costs and increase flexibility for regulated entities. Some of these design elements could include:

- multi-year compliance periods
- allowing for banking of compliance instruments
- allowing for trading of compliance instruments between entities and across sectors
- a cost-containment compliance instrument reserve
- the use of alternative compliance options representing emissions reductions from non-covered sectors
- complementary policies and support for technological innovation that encourage the development of new tools for compliance

Designing the program with cost containment measures in mind is important for cost-effectively reducing emissions for regulated entities and Oregonians. Cost-effective emissions reductions support regulated businesses and citizens who are consumers of goods and services affected by the program, especially for those in low-income and impacted communities, who are particularly vulnerable to increases in energy costs.

### **Distribution and use of compliance instruments**

DEQ may design the greenhouse gas emissions cap and reduce program by creating a limit or cap on emissions over multiple economic sectors and issue compliance instruments, or permits to emit, representing allowable metric tons of emissions. The overall cap would be enforced by requiring regulated entities to turn in compliance instruments equal to the amount of greenhouse gases they emit. As the overall cap declines over time, so do the number of compliance instruments made available by DEQ. This incentivizes businesses to reduce emissions as a way to reduce their need for the increasingly scarce number of permits to emit.

Certain design elements relating to the distribution and use of compliance instruments can allow for greater flexibility and reduce costs. As discussed below, trading of compliance instruments can add flexibility and find lower cost emission reductions. Central to this is a tradable compliance instrument. These instruments can be introduced into the regulated sectors either directly to regulated entities or through an auction. However, DEQ does not believe the EQC has the authority to auction or otherwise sell rights to emit greenhouse gases. Therefore, direct distribution from DEQ of compliance instruments to regulated entities at no cost rather than distribution through an auction is an allowable mechanism that can still reduce costs for those entities. DEQ would describe how compliance instruments would be distributed to regulated entities in the program rules. This would provide certainty for businesses to be able to plan appropriately and ahead of time for operational changes they may need to make in order to meet compliance.

### **Compliance periods**

The length of a compliance period has implications for a regulated entity's suite of options when determining how to meet its compliance obligations at the lowest cost. Adoption of a one-year compliance period, for example, may not take into account variations related to economic cycles, weather, energy or commodity prices, prices for compliance instruments traded on the secondary market, or the development or implementation of on-site technology upgrades. There are existing cap and trade

programs in other jurisdictions that have opted for three- or four- year compliance periods to allow regulated entities time to explore least-cost strategies and to manage variability.

## **Banking**

Another flexibility strategy is banking, which allows regulated entities to use compliance instruments from one compliance period in a later compliance period. This rewards regulated entities for taking actions that result in emissions reductions early in the cap reduction schedule and allows them to benefit from those reductions over multiple compliance periods. If DEQ allows banking of compliance instruments, the regulated entity has the option to use or hold its compliance instruments for a future period in which fewer compliance instruments may be distributed to the entity. The ability to bank compliance instruments may be more cost effective for the regulated entity than having to purchase additional compliance instruments, which is discussed below.

## **Trading of compliance instruments**

Once distributed, these compliance instruments may be traded among the regulated entities. This cost containment mechanism works by allowing those with easier and lower cost emissions reduction opportunities to make those investments in their own operations and then trade or sell excess compliance instruments to entities that do not have the same emissions reduction opportunities. Trading may be one of the most useful design elements to increase flexibility and to support cost-effective emissions reductions.

Under the right set of conditions, trading on the secondary market can deliver many of the same benefits as distribution of compliance instruments by auction. It is important, however, to consider the scope of authority of the EQC for monitoring and setting limits on activity in the secondary market, if trading is allowed. The EQC and market participants should have an interest in maintaining the efficiency of the market, and preventing anti-competitive behavior, such as market manipulation.

The EQC likely could establish rules to require reporting on secondary market transactions for the purposes of price discovery and market monitoring. Knowing the cost of compliance instruments in a secondary market would aid in market monitoring and aid DEQ in understanding program costs.

Given authority limitations, it is unlikely that the EQC could directly set floor or ceiling prices for the secondary market. However, with appropriate monitoring and price discovery, there are other mechanisms at the disposal of DEQ and the EQC that could provide flexibility to regulated entities in time of market stress, such as compliance instrument reserves. DEQ will consider standards and reporting requirements that apply to secondary market participants in order to foster confidence in market activity and compliance instrument transactions.

Trading of compliance instruments could be allowed among entities within a sector or among sectors. Compliance instruments that can be traded among regulated entities and across regulated sectors would create the most flexibility. This would allow for a lower overall cost to the regulated entities across all the sectors by taking advantage of the most efficient emissions reduction opportunities.

DEQ may consider different emissions caps based on different metrics in different sectors. If one sector's caps are based on absolute massed-based emissions limits and

another sector's caps are based on intensity- or rate-based emissions limits, attention must be given to determine if the compliance instruments could be made compatible and tradable across sectors. If compliance instruments are compatible across sectors, or can be easily converted, this simplifies and better enables cross-sector trading.

### **Compliance instrument reserve**

The cap and reduce program could be designed to reserve a certain number of compliance instruments that are not immediately distributed to regulated entities and release them only under certain circumstances. For example, DEQ could create and hold compliance instruments that would only be released if prices on the secondary market reach a certain level indicating that emissions reduction measures have become too costly and burdensome and may be a strain on Oregonians, businesses and the state's economy. DEQ will consider standards and reporting requirements that apply to secondary market participants in order to foster confidence in market activity and compliance instrument transactions.

Another example would be if the supply is at a certain level below demand, or if it otherwise becomes challenging for regulated entities to obtain compliance instruments on the secondary market. The release of these reserved instruments under a clearly described set of conditions could increase the availability of compliance instruments, which may help to mitigate costs. DEQ would have to determine what price or other conditions could trigger a release of compliance instrument reserves to regulated entities.

DEQ must also determine how to identify which regulated entities receive additional reserve compliance instruments and under what conditions. These reserve instruments could be in addition to the amount of compliance instruments equal to the cap of allowable emissions, but this would mean the use of the reserve instruments would allow for an overall increase of emissions over the cap. Another option could be to withhold the reserved compliance instruments from out of the cap, separate from those that would be distributed, which means there would be fewer compliance instruments available under the cap unless the reserve amount was triggered.

Another consideration is the potential use of a compliance instrument reserve if emissions are below a historic baseline. For example, it is anticipated that 2020 emissions levels may be lower than recent years due to the economic repercussions of COVID-19. There is much uncertainty around whether lower levels of emissions will continue into the future, and perhaps into early years of the program. Setting a cap based on historic emissions, but holding some compliance instruments out of the cap in reserve could help account for potentially lower levels of emissions due to COVID-19 in the near-future. This approach could help keep emissions levels lower, but also ensures there would still be sufficient compliance instruments available, if needed due to activity rebound. The exact amount to reserve is difficult to know at this time without actual annual emissions data. Another issue to consider is whether compliance instruments in the reserve would be banked by DEQ from year to year.

### **Alternative compliance options**

Alternative compliance options may be used to allow regulated entities to comply with greenhouse gas emissions caps by acquiring emissions reductions from outside of the capped sectors. There may be emissions reduction opportunities available at a lower cost than the regulated entity could achieve in their own operations. DEQ is considering

allowing for these alternatives to count toward compliance in the program as a cost containment mechanism. Generally speaking, allowing for alternative compliance options can result in the same overall reduction of societal emissions at a lower overall cost. Examples of emissions reduction projects that may qualify as alternative compliance options include actions in the agricultural or forestry sectors and the destruction of ozone depleting substances with high global warming potential. While alternative compliance options can reduce costs overall, they may reduce incentives for regulated entities to find emissions reductions in their own operations through efficiencies or new technologies.

The implications of alternative compliance options were discussed in a previous issue brief and at technical workshop 3. In the cap and reduce program design, DEQ must determine what portion of compliance may be fulfilled through the use of alternative compliance instruments. To do so, DEQ will need to find the balance between the overall lowest cost reductions with ensuring some significant portion of reductions come from the regulated sectors.

### **Complementary policies and technology development**

A final element of cost mitigation is the complementary suite of federal, state and local policies that require or encourage greenhouse gas emissions reductions outside of the cap and reduce program. The suite of policies in Oregon that encourage clean energy and lower emissions draws an economic focus on reducing emissions and promoting technological innovations, which may ultimately be useful for regulated entities. As these policies promote technologies and practices, regulated entities may find additional tools to use for cap and reduce compliance.

EQC and DEQ authorities do not allow for revenue-raising and therefore additional funds will not be raised to invest in communities or technologies to help reduce emissions. Additionally, other agency requirements for greenhouse gas emissions reductions may or may not be considered as part of helping regulated entities achieve compliance with this program. For example, complying with the Oregon Clean Fuels Program may help to reduce compliance obligations associated with tailpipe emissions that may be subject to a cap and reduce program. Alternatively, alternative compliance options cannot be created from projects already meeting government mandates.

### **Impacted communities and small businesses**

Employing varying cost containment mechanisms in a cap and reduce program design is also of interest in order to protect impacted communities that might see a disproportionate impact from both climate change itself, air quality impacts from health-hazardous co-pollutants emitted alongside greenhouse gases, and costs that come from the cap and reduce regulation. As part of this scoping process, DEQ is working to focus on impacted communities, their needs, and creative design elements within existing authorities that can help mitigate or remove economic burden to Oregonians in impacted communities. DEQ will provide a separate issue brief and conduct a dedicated technical workshop to address ways to protect impacted communities.

### **Workshop format**

DEQ will largely structure the workshop on cost containment based on the headers denoted above. DEQ would like to explore creative ideas for cost effective emissions reductions and the pros and cons associated with different program design options and available cost containment and flexibility mechanisms. The agenda will have a set time to discuss each sector or issue, as identified by DEQ. These workshops are not creating a program, but are to introduce key issues and help inform DEQ's future rulemaking and program design. DEQ encourages conversations across the table and across sectors during the workshops.

### **Key workshop discussion topics**

- What compliance period rules and banking rules are useful for cost containment and increased compliance flexibility? What is an appropriate compliance period?
- Should the program allow for trading? Under what circumstances? What considerations are there for maintaining efficiency and avoiding market manipulation in a secondary market? How should the program account for sectoral differences if allowing for trading?
- Should there be a compliance instrument reserve? If yes, what portion of compliance instruments should be held in reserve, and under what circumstances should DEQ distribute from the reserve?
- What considerations need to be identified and discussed for understanding potential program costs for impacted communities?
- What considerations need to be identified and discussed for understanding potential program costs for small businesses?

### **Related topics**

A well-functioning and coherent cap and reduce program or programs will include many carefully considered and integrated elements. These choices depend on related policy or real world considerations. Rather than discuss all choices simultaneously, DEQ will host topic-specific technical workshops to address program design options. DEQ acknowledges there is crossover among design elements and workshop topics, but will focus this workshop's conversation on the topic at hand as described above. Below is a list of related topics for subsequent technical workshops and some key ways in which these topics relate to cost containment:

- **Program scope:** The available emissions reductions and associated costs, therefore cost effectiveness of complying with the program, will be determined by the sectors and sources of emissions covered by the program.
- **Program stringency:** The overall cap on emissions and how quickly or slowly caps decline overtime impacts ease of compliance for regulated entities that must reduce emissions to under the caps.
- **Alternative compliance options:** Creating more flexibility and multiple options for pathways to compliance can help contain the costs of complying with the program.
- **Distribution of compliance instruments:** Cost-containment mechanisms, such as allowing for trading of compliance instruments, relates to the distribution of such instruments by creating flexibility and optionality if a regulated entity is distributed too few or too many instruments.

- **Impacted communities:** Mitigating or removing economic burden to impacted communities due to costs associated with program compliance is an important program design consideration.

### **Additional opportunities to engage**

Prior to opening a formal rulemaking, DEQ will host topic-specific workshops for in-depth technical discussions and town hall-style public meetings for broader conversations and public comment.

For more information on how to engage in the conversation, please visit DEQ's webpage: [www.oregon.gov/deq/ghgp/Pages/capandreduce.aspx](http://www.oregon.gov/deq/ghgp/Pages/capandreduce.aspx).

### **Alternative formats**

DEQ can provide documents in an alternate format or in a language other than English upon request. Call DEQ at 800-452-4011 or email [deqinfo@deq.state.or.us](mailto:deqinfo@deq.state.or.us).