

INTEROFFICE MEMORANDUM

DATE: **January 31, 2003**

TO: **John Steib, Director
Air Permits Division**

THRU: **Arturo J. Garza, Manager
Technical Program Support Section**

FROM: **Emissions Banking and Trading Team**

SUBJECT: **Circumvention of MECT**

The Mass Emission Cap and Trade Program (MECT) was established in December 2000 to provide flexibility for facilities to comply with the NO_x SIP requirements under 30 TAC Chapter 117. The program was structured to provide affected sites an allowance allocation based on historical emissions, that is reduced each year to a final allocation based on the required SIP limits. In providing flexibility, the program incorporated the open-market trading of allowances. This measure gives affected sites the discretion to control emissions or purchase excess allowances on the open market. In addition, to encourage and facilitate trading of allowances, the program allows unused allowances to be banked for one additional year and used for compliance in the following control period. Certain restrictions, however, were imposed on the banking and use of allowances to insure that the reduced cap levels were maintained. Specifically, if banked allowances are not used in the control period after which they were allocated, they expire and are no longer eligible for use. Also, when allowances are deducted from a company's compliance account, the most recently allocated allowances are deducted first. These two restrictions prohibit companies from "stacking" allowances to delay compliance with the program and further delay the H/G nonattainment area from reaching attainment.

Several inquiries as to whether various trading strategies circumvent applicable MECT rules have been submitted to the Emission Banking and Trading Team. The following are two examples of proposed strategies for which inquiries have been received:

1.) Company B chooses to sell all of its current year (CY2003) allowances to a third party with a contractual agreement to purchase back the same vintage year and amount of allowances the following year (CY2004). In this manner, the company's compliance account is void of the most recently allocated allowances and only possesses excess allowances from the previous control period for compliance with their 2003 actual emissions. The following year, Company B would "purchase" the CY2003 allowances back for use in complying with its 2004 actual emissions and transfer its most recently allocated allowances (CY2004) to the third party. Company B could do this every year so as to never possess allowances allocated for that control period, thereby avoiding loss of allowances due to expiration.

2.) Company C chooses to sell a portion of or all of its current year (CY2003) allowances to one or more buyers. Company C then purchases excess allowances from the open market the previous year (CY2002) to cover its actual emission for the control period.

Trading strategies, as in example #1, where contracts or agreements are made to trade current year allowances with the guarantee to attain an equivalent amount of the same vintage year allowances in a future control period will fall under consideration by the commission for circumvention of the Mass Emissions Cap and Trade rules. Trades of this nature, employing a private "escrow" type account for the holding of allowances, serve no other purpose other than avoiding expiration of older allowances and can be considered as a method to circumvent the regulatory requirement to use the



most recently allocated allowances first, and could allow a company to realize a delay in the reduction of its allocation without purchasing excess allowances from the open market. Trading strategies which utilize the open market, as in example #2, are allowed by the rules governing the Mass Emissions Cap and Trade program.