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COUNCIL OF ECONOMIC ADVISERS

February 25, 1991

TO: MICHAEL BOSKIN
RICHARD SCHMALENSEE

FROM: HOWARD GRUENSPECHT *HB*

SUBJECT: Clean Air Act Implementation: The Return of the Scrubbing Issue

The system for allocating Phase I bonus allowances for scrubbing in the acid rain trading program of the recently enacted Clean Air Act could have a major impact on how much cost-ineffective scrubbing for removal of sulfur dioxide is encouraged. Based on preliminary consultations with the utility industry, it appears that the available pool of 3.5 million bonus allowances for Phase I scrubbing may be significantly oversubscribed -- that is, given access to bonus allowances provided under the Act, more utilities may want to scrub in Phase I than the framers of the legislation had contemplated.

If forecasts of excess demand for bonus allowances are correct, a system that allocated the maximum number of bonus allowances to the smallest number of applicants would minimize the extent of cost-ineffective scrubbing. A strict construction of the "in order of receipt" language of the statute would achieve this outcome. Note that even though some units might be shut out of the bonus allowance pool under this approach, owners of these units would still chose to scrub if scrubbing was truly the most cost-effective approach to emissions reduction.

An alternative allocation scheme is to provide bonus allowances on a pro-rata basis to all units that apply on the same day of the program. Thus, if the bonus program is oversubscribed by 25 percent on its opening day, each unit would receive 80 percent of the allowances provided under the statutory formula. If none of the units had a break-even requirement of more than 80 percent for scrubbing, the pro-rata system would, in this example, increase Phase I scrubbing by 25 percent over the strict construction approach. Moreover, for reasons outlined above, the incremental scrubbing encouraged under this approach would necessarily be cost-ineffective. This concern is not academic, since the bonus allowances in question have significant market value. The modeling studies generated in support of the Clean Air Act place a value of between \$1.05 billion and \$2.1 billion (both figures in 1989 dollars) on the 3.5 million allowances in the bonus pool. Access to a share of this pie can make a significant difference in a close decision.

The pro-rata approach is supported, for obvious reasons, by high-sulfur coal mining interests. From a lay perspective, and possibly a utility perspective, it might also be seen as more equitable than the strict construction of the "in order of receipt" approach, since the latter gives some applicants their full formula allocation of bonus allowances while others get nothing.

This issue, which will soon be the subject of EPA rulemaking, is already being widely discussed within EPA's Acid Rain Advisory Committee. It might be helpful for the Administration to provide guidance to EPA as to its views on this matter. Otherwise, we could be presented with a consensus (or near-consensus) that is hard to buck.

In the late (but not lamented) debate over the acid rain title of the Clean Air Act, the Administration favored an allowance trading approach in which all emission reductions approaches (scrubbing, fuel switching, and energy conservation) were placed on an equal footing. In other words, the Administration placed cost-effectiveness above other concerns. Consistency with our Clean Air principles would favor a strict construction of the statutory language, which gives us (and low sulfur coal interests) only the minimum amount of cost-ineffective scrubbing that we bargained for in accepting the 3.5 million ton bonus pool arrangement.

While the economic efficiency case for allocation using strict construction or a like approach is clear, non-economic or equity considerations (the latter, as always, in the eye of the beholder) may cut the other way. I call the matter to your attention now because the Administration spilled so much blood to avoid a tilt towards excessive scrubbing.

One way or another, a decision regarding the allocation system for the bonus allowances will be made at a high political level. The only question is whether we wait for EPA to bring the issue before us, or act to provide direction on our own initiative.

cc: HB, AJ

Fax Cover Sheet



U.S.EPA

Office of Policy Analysis

Fax # (202) 382-5605

Tel # _____

To: Jeff Holmstead

Fax # 456-7929

From: Alex Cristofaro

Comments: _____

Memo RE Title III
implementation per
our discussion

Number of pages to follow: 3

91-0091



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

FEB - 5 1991

MEMORANDUMOFFICE OF
POLICY, PLANNING AND EVALUATION

SUBJECT: Implementation of Title III of the Clean Air Act

FROM: Terry Davies, Assistant Administrator
for Policy Planning and EvaluationTO: Bill Rosenberg, Assistant Administrator
for Air and Radiation

In the race to implement Title III according to the ambitious timetable set by Congress, we should not lose sight of our policy options under the new title. This memo discusses a variety of approaches available to the Agency both for defining source categories and setting emission standards for those categories under the new program.

DEFINING SOURCE CATEGORIES

Title III requires the Administrator to establish the categories of sources that will be subject to regulation. Each grouping of sources will be subject to the same national emission standard, but the Act gives the Administrator broad discretion in defining categories and subcategories of sources. *The issue is what criteria should be used to group similar kinds of sources (i.e., to define source categories)?*

One option is to group emission points according to similarity of function. For example, all process vents at chemical plants could be defined as belonging to the same "source category" -- and thus subject to the same emissions standard -- regardless of individual circumstances. While requiring relatively little information to implement, the disadvantage of this approach is that it could result in expensive control equipment being installed at many emission points that pose only minimal threats to the environment.

Alternatively, vents could be grouped according to the toxicity and volume of their emission streams. Vents characterized by low volume or low toxicity emissions would be grouped together and face different standards than those with higher flow rates and more toxic emissions. Quantitative risk assessment could be used to assist in defining source categories. While

requiring more information to define source categories, this approach is more likely to ensure that emission standards will be cost effective.

SETTING EMISSION STANDARDS

Once source categories are established, the issue becomes how to set emission standards. The Act mandates that for existing sources, standards must reflect *at a minimum* the level of control achieved by the "best performing" twelve percent of the sources in the source category. The Agency may issue more stringent standards after considering costs, energy impacts, environmental impacts and other factors.

One issue that must be confronted consists of how to define the term "best performing"? One option is to define it purely in terms of the air pollution control efficiency of a given technology. A source achieving 98% removal is thus defined as a better performer than a source achieving 95% removal.

Another interpretation would be to consider a wider variety of factors in evaluating "performance". These could include cross media pollution, toxicity and exposure, energy impacts, and even costs. For example, the performance of a control technology with a 98% efficiency may be considered inferior to that of a 95% efficient device if it entails exorbitant cross media pollution, energy impacts, or costs. The Act gives the Administrator broad discretion to define "performance" in this regard. Defining "performance" will be critical in establishing the floor for the stringency of emission standards.

Similarly, in establishing the final emission standards, the Agency could evaluate control options based on their relative cost-effectiveness in addition to their technological feasibility. Continuing with the above example, the Agency could weigh the cost of adopting a 98% control efficiency standard against the resulting risk reductions to determine whether such a standard should be adopted.

ALLOWING TRADING

Alternatively, if it is infeasible to consider risks in program implementation, the Agency could promulgate a tradeable emissions program for air toxics. This program would establish a national, regional, statewide, or facility-wide total emissions level that corresponded to the emissions level achieved by the best controlled 12% of sources in a source category. For national, regional, and statewide programs total emissions levels would have

to be extrapolated from emissions levels at the best performing 12% of sources. The Agency could also choose emission levels that corresponded to implementation of a particular control device or pollution prevention scheme. These levels would be achieved by distributing emissions allowances permits to sources corresponding to baseline emissions and then limiting the availability of these permits to eventually equal the level of emissions desired. This program would achieve the same emissions reductions on a nationwide basis as a purely technology based program would but at a much lower cost since firms could comply in the most cost-effective manner possible.

* * * * *

Congress established ambitious time tables for the Agency in Title III. In order to meet these deadlines, the policy issues raised in this memo must be resolved by Agency management, since they have major implications for the type of information to be gathered in the development of emission standards. I look forward to discussing these issues with you in the near future.

cc: F. Henry Habicht, II
E. Donald Elliot