May 3, 2001

Lori F. Kaplan, Commissioner
Indiana Department of Environmental Management
100 North Senate Avenue
Indianapolis, Indiana 46209-9932

Dear Commissioner Kaplan:

I am writing in response to your March 22, 2001 letter to Rob Brenner. We appreciate Indiana's commitment to ensure adoption of regional controls to regulate NOx in response to the United States Environmental Protection Agency's (EPA) Nitrogen Oxides (NOx) State Implementation Plan (SIP) Call. We have also been impressed with Indiana's stakeholder involvement on this rule and agree that there has been good communication and cooperation between the State and federal agencies.

Regional NOx SIP rules are especially important to keep on track as an essential element of the attainment demonstration for the Northwest Indiana 1-hour ozone nonattainment area. The EPA agreed in a consent decree with the Natural Resources Defense Council to propose an attainment demonstration Federal Implementation Plan (FIP) by October 15, 2001, if EPA had not fully approved the Northwest Indiana attainment demonstration by that date, including rate-of-progress through the attainment year. Indiana's NOx rules need to be final and effective in the State for us to issue a final full approval of the Northwest Indiana attainment demonstration SIP. If EPA cannot take action by October 15, 2001, on the attainment demonstration SIP because of the lack of approvable NOx rules, EPA would need to address the NOx rules as part of our obligation to propose an attainment demonstration FIP for the area by that date. Below we have provided more detailed comments on the issues presented.

Section 126

You expressed concern that, beginning in 2004, sources in Indiana could be subject to overlapping requirements and allocation procedures under the section 126 Federal trading program and the State trading program. The EPA and the States have worked collaboratively for many years now to address the interstate NOx transport issue and, as you note in your letter, EPA strongly supports addressing the issue through State action. Moreover, for reasons of simplicity, efficiency, and ease of administration, EPA is committed to the concept of a single unified

trading program between sources trading under the section 126 rule and sources States have chosen to regulate through a trading system under the NOx SIP Call. Consistent with these aims, EPA agrees that it does not make sense to have two sets of trading program budgets and allocations apply to the same sources during the same time frame.

Under certain circumstances in which the section 126 sources in a State were no longer significantly contributing to downwind nonattainment, we believe it would be appropriate to propose to withdraw the section 126 findings of significant contribution and the accompanying requirements for such sources. Specifically, where a State's regulation is approved into the SIP and requires at least the same total quantity of reductions from the same group of sources as would have been controlled under the section 126 rule, we believe it would be appropriate to propose withdrawal of the section 126 requirements. The EPA believes it would be reasonable to find that, as of the required date of compliance with the State regulations, such sources were no longer contributing significantly to downwind nonattainment for purposes of section 126.

Under Indiana's proposed regulations, all of the section 126 sources in the State would be covered by the State rule, and the rule requires those sources to reduce a quantity of emissions greater than the quantity of reductions required under the section 126 rule. Under these circumstances, assuming that Indiana's SIP revision is otherwise approvable, EPA intends to propose to withdraw the section 126 findings and requirements for sources in the State as of May 1, 2004, as you have requested. We anticipate commencing this rulemaking once we have received a decision from the U.S. Court of Appeals for the District of Columbia Circuit on the litigation on the section 126 rule. The court is not required to render a decision within any specified time frame. However, we expect the court is likely to rule within the next two months.

As you note in your letter, State rule would not have the effect of withdrawing the section 126 findings, which could only be modified through federal action. As you know, the section 126 findings and requirements are contained in a final rule. Thus, any modifications, such as those you have requested, could only be made through further rulemaking under the section 126 rule. However, the current draft of the Indiana regulations contains a provision (326 IAC 10-4-1(c)) that suggests otherwise. In light of EPA's intention to propose withdrawal of the section 126 findings and requirements for the State as of May 1, 2004, we believe that you should remove this provision, consistent with what EPA could approve as a SIP revision.

In your letter you also asked for clarification on allowance allocations, banking and early reduction credits. If EPA approves Indiana's SIP and finalizes a rule to withdraw the section 126 findings and requirements as of May 1, 2004, EPA would administer the NOx Allowance Tracking System in the following manner. For 2003, EPA would issue allowances for the section 126 sources. For 2004 and beyond, only Indiana's SIP allocations would be issued, not the section 126 allocations. Sources will be able to bank allowances allocated in 2003 under the section 126 rule (to the extent not needed for compliance in 2003) and use those allowances for the purposes of meeting the requirements of the Indiana Trading Program under the NOx SIP

Call. Those allowances will of course be subject to the banking provisions of the State's NOx rule.

In addressing the interaction between trading program requirements under the section 126 rule and the State's NOx SIP, it will also be necessary to reconcile the use of the compliance supplement pool. In particular, there are a few key issues that would have to be appropriately resolved in order to support a proposal to withdraw the section 126 requirements.

First, the compliance supplement pool provisions in the NOx SIP Call and the section 126 rule clearly contemplated that there would be a single compliance supplement per State under one program or the other. There is no justification in the rulemaking records to support distribution and use of two separate compliance supplement pools (unless sources were simultaneously subject to two separate requirements to hold non-interchangeable allowances, which EPA believes no party supports). If EPA withdrew the section 126 rule requirements for Indiana as of 2004, it appears that it may be administratively simplest and most appropriate for Indiana, rather than EPA, to distribute the State's compliance supplement pool. Thus, the State would be distributing compliance supplement pool allowances for use by the section 126 sources beginning in 2003 and would be distributing additional allowances for use by other sources subject to the State trading program beginning in 2004. This approach, of withdrawing the compliance supplement pool under the section 126 rule and deferring to Indiana's distribution of the compliance supplement pool under its own rule, would need to be implemented through rulemaking. Thus this change could be included in a proposal to withdraw the section 126 requirements for sources in Indiana.

Regardless of which entity distributed the compliance supplement pool for Indiana, a second key point is that the compliance supplement pool allowances could be used for compliance with either the section 126 requirements or the State requirements. However, under the circumstances where the State, rather than EPA, distributed the compliance supplement pool allowances, EPA intends as part of a proposed withdrawal of the section 126 requirements to allow the State to fully coordinate the program by extending the use of the entire pool until 2005. Currently, the compliance supplement pool allowances distributed under section 126 would expire after completion of the 2004 end-of-season reconciliation process, while compliance supplement pool allowances distributed under the State's program would expire after the 2005 end-of-season reconciliation process is completed. However, if the State, rather than EPA, distributed the compliance supplement pool allowances, it would make sense for all of the allowances to expire after the 2005 end-of-season reconciliation process is completed. This would extend the life of the compliance supplement pool allowances that would have been allocated under the section 126 program by one additional year. However, the purpose of the compliance supplement pool is to provide additional assurance of sufficient allowances in the first two years of the trading program, and the State trading program begins in 2004. Therefore, extending the use of the entire pool until 2005 allows for a fully coordinated program.

Third, if Indiana were to have sole responsibility for distributing the compliance supplement pool for the State, it would be important for the State to take account of the section 126 sources in the State, as well as the sources covered only by the State program. The current

draft of the Indiana rule would provide allowances from the compliance supplement pool for early reductions made in 2002 and 2003. The EPA recommends that Indiana consider also providing allowances from the compliance supplement pool for early reductions made in 2001, to assure that the section 126 sources have a full two years to earn early reduction credits before their compliance deadline of 2003.

Fourth, the sources covered by section 126 should not be able to earn early reduction credits for any reductions made in 2003. The Indiana draft rule provides that reductions already required by federal law are not eligible for early reduction credits. The EPA interprets this language as precluding sources covered by section 126 from being granted compliance supplement pool allowances for reductions made in 2003. Indiana should either confirm that you agree with this interpretation or revise the regulatory language to provide explicitly that sources covered by section 126 are not eligible for compliance supplement pool allowances for reductions made in 2003.

The fifth key concern is specific to States such as Indiana where the NOx SIP Call covers the full State, but the section 126 rule covers only a portion of the State. The State-wide compliance supplement pool is substantially larger than either the compliance supplement pool for Indiana under section 126, or, for that matter, the entire budget for the section 126 sources in Indiana. Thus, if the State were to distribute the full compliance supplement pool for Indiana in a manner that allowed the section 126 sources to use all of those allowances in 2003, the section 126 sources might not need to make any emissions reductions in 2003. This would undercut the benefits of the section 126 requirements and make it difficult for EPA to justify a proposal to withdraw the section 126 program for Indiana.

A likely way to remove this concern would be to limit when the compliance supplement pool allowances can be used. Under this approach, Indiana could distribute the entire compliance supplement pool to sources according to the approved State SIP,
but only the first 2,454 compliance supplement pool allowances (i.e., the quantity equal to the compliance supplement pool under the section 126 rule) distributed could be used in 2003. The remainder could be used beginning in 2004. This restriction would be simple to implement because every allowance has a “vintage” and can only be used beginning in the year of its vintage. Thus, the State rule would need to limit the number of compliance supplement pool allowances with a 2003 vintage so that they equal the quantity of compliance supplement pool allowances available under the section 126 rule.

The State can distribute the compliance supplement pool allowances at any time after the early reductions have been verified, but no later than the date that the source claiming the early reduction credit becomes subject to the requirement to hold allowances. Thus, for section 126 sources making early reductions, the State can distribute compliance supplement pool allowances up to April 30, 2003. For all other sources making early reductions, the State can distribute compliance supplement pool allowances up to May 30, 2004.

For example, say a State has 1000 allowances in its compliance supplement pool and the section 126 compliance supplement pool for that State has 200 allowances. Sources in the State have 500 tons of early reductions in 2001 and 500 tons of early reductions in 2002. Under this approach, the State may give up to 200 compliance supplement pool allowances that could be used in 2003 (i.e., "vintage" 2003 allowances), and the remaining compliance supplement pool allowances that could be used in 2004 ("vintage" 2004 allowances). The State could distribute all of these allowances at any time before April 30, 2003. Alternatively, the State could distribute some of these allowances before that date and the rest (for sources not covered by the section 126 requirements) at any time before May 30, 2004.

I hope that this explanation fully addresses your concerns about the interaction of the section 126 rule and Indiana's NOx rule. If, however, you have any further issues or concerns on this point, please let us know, and we will look forward to resolving them expeditiously.

Construction permitting requirements

We understand that Indiana sources would like confirmation from IDEM that the installation of NOx controls in response to the NOx SIP Call (for example, selective catalytic reduction--SCR--and ancillary equipment necessary to support its function) will be considered a pollution control project and, as such, eligible for an exemption from major new source review (NSR). It is our position that under both the NSR regulations and our 1994 guidance, which are discussed below, the installation and operation of SCR for compliance with the NOx SIP Call qualifies as a pollution control project.

As you are aware, the current federal major source NSR regulations define the types of projects that generally qualify as utility pollution control projects and the circumstances under which those projects may be excluded from major NSR. Under the regulations, which contemplate a case-by-case evaluation, a utility installing NOx controls pursuant to the NOx SIP Call may be considered a pollution control project and qualify for an exclusion from major NSR provided the project will not render the affected unit less environmentally beneficial and does not result in an increase in emissions of any air pollutant where such increase would cause or contribute to a violation of any ambient standard, PSD increment, or visibility limitation. For pollution control projects undertaken to comply with the NOx SIP Call and not covered by the regulatory exclusion, EPA's criteria for providing a case-by-case exclusion from major NSR for such projects is explained in the July 1, 1994 guidance memorandum titled "Pollution Control Projects and New Source Review (NSR) Applicability." The July 1, 1994 memorandum reflects our current policy and guidance on the types of projects that may be considered pollution control projects and the safeguards that must be met for an exclusion to be allowed.

Because the existing regulations and guidance rely on a case-by-case approach to evaluate proposed pollution control projects, we feel that it would not be beneficial to issue more detailed procedures or criteria at this time. We are, however, willing to work with IDEM to help resolve case-by-case issues that may not be clearly addressed in the available guidance.

Multipollutant compliance path

The inclusion of an alternative compliance plan -- which exempts from the allowance holding requirement and end-of-season compliance deductions those large Electric Generating Units (EGUs) and large non-EGUs boilers that make reductions without traditional NOx control technologies -- appears to be contrary to §51.121(b)(1). Under §51.121(b)(1), a State must include in its SIP measures adequate to prohibit NOx emissions projected to cause overall emissions to exceed the State's 2007 budget. The Alternative Compliance Plans that have been proposed to EPA do not appear to provide such assurance. In fact, the Alternative Compliance Plan included in Ohio's draft (attachment 3), on which you asked us to comment, does not appear to require any NOx
reductions from exempt units until 2008 or require reductions from other sources to offset the shortfall in reductions from exempt units before 2008. To the contrary, while under the Alternative Compliance Plan no allowances are deducted to cover the exempt units' NOx emissions before 2008, the exempt units are apparently allocated allowances before 2008. These allowances can then be sold or banked for future use. The EPA cannot approve Alternative Compliance Plan provisions such as Ohio's.

Moreover, providing an exemption from the program is not necessary to encourage innovation in NOx control technology. Sources subject to the program already have an incentive to reduce NOx emissions below their allocation, since they can sell surplus allowances on the market. In addition, from the standpoint of program administration, the Agency cannot efficiently operate its NOx Allowance Tracking System (NATS) in such a way as to implement some of the specific provisions that we have seen in proposed alternative compliance plans. For example, an exempt unit would apparently lose its exemption and have allowances deducted for emissions for any ozone season in which the unit failed to meet the required mercury or sulfur reductions. This would mean that, unlike any other units, the need to make end-of-season compliance deductions for units with alternative compliance plans could change from year to year.

Proposals to increase available allowances in early years of the program.

The compliance supplement pool was created to provide sources with an additional pool of allowances during the initial two years of the program. This is the only pool of allowances available to sources beyond the trading program budget. As we have stated consistently, EPA cannot approve a State submission that would increase the size of a State's compliance supplement pool nor can we approve the allocation of early reduction credits beyond the level of the compliance supplement pool.

In reference to the language in Ohio's draft rule that you included, the rules governing the NOx SIP Call do not allow for credits, beyond those in the compliance supplement pool, to be made available for reductions achieved during the month of May, 2004. Distributing allowances beyond those specified in a State budget and compliance supplement pool would be grounds for a SIP disapproval. A May 1, 2004 compliance date does not justify an extra allowance allocation, particularly since a five-month trading budget is already provided despite the May 31, 2004

compliance date. Prohibiting banking these excess credits does not alleviate EPA's concerns because it would still be an increase in the size of the compliance supplement pool.

Flexibility and cost saving through voluntary reductions.

The EPA supports an approach to NOx reduction that encourages the most cost-effective measures. In developing the 1997 NOx SIP Call, EPA invested significant effort to determine what controls were reasonable and cost effective. While we wanted to ensure that these cost-effective reductions were achieved, we did not want to preclude States and sources from working together to determine measures that were potentially more cost effective in the State. For this reason, we finalized Statewide budgets instead of specific source emission limits.

In order to implement the additional flexibility in the SIP Call for source categories other than large EGUs and large non-EGUs to generate NOx allowances, it is important and required that the reductions be measured and verified to the same level of accuracy as required for large EGUs and non-EGUs under part 96. The SIP must also explain in detail how the reductions will be achieved, measured, and verified.

Reductions made by sources other than large EGUs and non-EGUs may be used to compensate for fewer reductions by EGUs and non-EGUs to the extent that the SIP provides a detailed accounting of the emissions and reductions from these sources and has fully adopted State rules that require emission reductions from these sources. Specifically, the emissions budget must include: which sources are required to reduce emissions; what quantity of emission reductions are required and how they will be achieved; how the emission reductions will be accurately verified; and how the emissions reductions will be used in the determination of the State emissions budget. This approach could be implemented by: having a separate emission reduction program for these sources; making these categories of sources full participants in the trading program; or allowing these sources to opt-in voluntarily as full participants. In the latter two cases, each source, including area and mobile sources, would have to meet the emission monitoring and accountability requirements under part 96. For the integrity of the trading program, all sources in the trading program must be able to monitor their emissions with the same high level of accuracy, i.e., as required under part 75. The language included in attachment 5 of Indiana's letter does not provide adequate assurance that the reductions would be measured according to part 75 and would therefore be unapprovable.

We would like to reemphasize that we appreciate Indiana's commitment to and continued efforts on this rule. These regional NOx reductions are one of the most significant steps that we have taken to control ozone levels since the 1990 Clean Air Act Amendments, and your diligence and attention in developing your program is critical.

Please do not hesitate to contact me or Lydia Wegman if you have further questions.

Sincerely,

/s/

John S. Seitz
Director
Office of Air Quality Planning
and Standards

cc: Jeffrey Holmstead
Rob Brenner
David Ullrich
Bharat Mathur
Jay Bortzer