

**Before the
ILLINOIS POLLUTION CONTROL BOARD**

**Testimony of Mary Schoen
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IN THE MATTER OF:

PROPOSED NEW 35 ILL. ADM. CODE 217,	}	
SUBPART W, THE NO_x TRADING PROGRAM	}	
FOR ELECTRICAL GENERATING UNITS,	}	R01-9
AND AMENDMENTS TO 35 ILL. ADM. CODE	}	(Rulemaking - Air)
211 AND 217.	}	

I. Introduction

Enron Corp is a diversified energy company developing gas-fired electric generation projects in several states in response to a nation-wide demand for clean, efficient electric generation. Enron's Lincoln Energy Center will not only provide Illinois the new generation needed to insure an adequate availability of low-cost, reliable power, but also jobs and tax revenues. Enron Corp. appreciates the opportunity to present this testimony to the Illinois Pollution Control Board.

As was discussed in the recent hearings on natural gas-fired electric generating facilities before the Illinois Pollution Control Board, Enron's facility and others like it are "merchant" generating plants. The costs and risks of financing, constructing, and operating these facilities are born by the plant developer rather than by the electric ratepayers in Illinois. This means that the decisions about where to build and when to run a facility are extremely sensitive to the regulatory framework in a given state. These plants do not need special treatment, but rather an open competitive marketplace and equitable, even-handed regulatory environments in which to operate.

Enron Corp is concerned that Lincoln Energy Center and other new generating plants are going to be negatively affected by the proposed Subpart W. And as a result, that Subpart W will discourage the growth of new power projects, slow the development of badly needed new generation and increase the cost of NO_x reductions required under the SIP call. Enron suggests four changes to the rule that would remedy these shortcomings.

II. Background

On October 27, 1998, the U.S. Environmental Protection Agency (EPA) promulgated the "Finding of Significant Contribution and Rulemaking for Certain States in the Ozone Transport Assessment Group Regions for Purpose of Reducing Regional Transport of Ozone," commonly

known as the SIP call. The SIP call required 22 states including Illinois to develop plans to meet a seasonal NO_x "budget." For large boilers and power generators, the SIP suggested the use of a NO_x cap and trade program.

Under this program, the EPA set a seasonal (May through September) tonnage cap for NO_x emissions from the affected sources in each state. The program creates NO_x allowances that are a permit to emit one ton of NO_x. The allowances are allocated to the affected sources and affected sources must have emission allowances (permits) equal to their ozone-season emissions at the end of the season. Sources are not required to limit their emissions to their allocation. They can over- or under-control and trade the allowances. However, the initial allocation of allowances is a critical factor since it comprises the distribution of the "wealth" of the trading program.

The EPA provided a "Model" emissions trading rule for the program. In the EPA model rule, allowances are allocated to all sources based on their heat input times an allocation factor of 0.15 lb NO_x/MMBtu. As new electric generators are built and come into the system, they receive allowances at the same rate as the old plants. A "new source set aside" is established to provide allowances for new plants during the initial period when they are operating but have not established a historical record of heat input on which a regular allocation can be based. In the model rule, the new source set aside is set at 5 percent of the budget during the initial 3-year allocation period and decreases to 2 percent per year for the subsequent annual reallocation periods. All sources in the model rule receive the allowances free of charge.

Because the emission budgets in a given state and the total allocations in the ozone transport region are capped, the allocations do not affect the eventual emissions from power generators. They do, however, affect the distribution of wealth in the system and the profitability of the affected sources. They also affect the overall cost of the program to the public. The theory of the cap and trade program is that the market will determine where the most cost-effective reductions can be made. If allowances are distributed equally to all affected sources, then the sources can make rational economic decisions. If, however, the allocations are skewed to one group or another, then the cost saving function of the program will be skewed and the lowest cost reductions will not be achieved. The design of the program in a given state is critical to achieving cost-effective reductions and insuring the market mechanism envisioned by the EPA works. Unfortunately, Subpart W goes against the principles of the EPA model rule, and the citizen's of Illinois will ultimately pay the price of a NO_x SIP that disincentivizes the development of clean generation.

III. Subpart W Comments

Although many portions of the trading rule are mandatory in the SIP call program, the EPA did leave the initial allocation of the allowances to the individual states. In developing Subpart W, Illinois has diverged significantly from the allocation philosophy recommended by the EPA.

IEPA developed the allocation approach after "extensive negotiations with [existing] affected sources"¹. Developers of new power plants sources were not included in this process. The resulting allocation methodology is referred to as the "fixed/flex" approach.

The initial allocation of allowances in 2003 provides allowances only to plants that were in operation by January 1, 1995. Under the fixed/flex approach, the allocations to existing sources are fixed, to varying degrees until 2008. That means that the existing sources receive the majority of the allowances through 2008 regardless of how much they run or how much they emit. They will receive these allowances even if they are shut down and have no emissions. In the EPA model rule, the plants that actually provide the state's power receive the allowances. In Subpart W, the existing plants receive grandfathered allowances regardless of whether they provide any power to the state.

Under the "flex" portion of the rule, some of the remaining allowances are allocated to the new sources at their very low permitted emission levels. The formula is designed in such a way that new sources will not receive enough allowances to cover their actual emissions, even though they are as much as 10 times cleaner than the nominal 0.15 lb/MMBtu emission rate. Despite the high cost control systems required of these new plants, they will be required to purchase allowances, possibly from their competitors, in order to operate under this rule.

While IEPA and the owners of existing plants argue that retrofit controls on existing plants are more costly than controls on new plants, actual experience indicates the opposite. The cost of NO_x controls for large coal-fired plants is expected to range anywhere from \$1,500 to \$5,000/ton of NO_x reduced. However, the reduction cost of installing the SCR that is required on an already low-emitting gas-combined cycle plant can be \$5,000/ton or higher. Having paid this high price to control their emissions, the new plants have as much claim as existing plants to the benefits of the trading program and should be treated equitably.

Finally, although there is a new source set aside, the large number of new plants being built in Illinois will rapidly exhaust the set aside and there will not be enough allowances to go around. Moreover, plants that go on line after May 1, 2002 will be required to pay for any new source set asides that they receive at market prices.

Existing source argue that the EGU budget is based upon their continued operation and that they should be compensated for "loss of allowances" allocated to new EGUs. This misstates the development and philosophy of the trading program. The EGU budget was based on growth in power generation in Illinois at a constant allocation rate of 0.15 lb/MMBtu. The budget calculation did not determine what entities would provide that growth. In fact, new plants will actually provide much of the growth. Those new plants should be allocated the growth portion of the budget at the full allocation level set by the EPA.

¹ IEPA "Statement of Reasons" In the Matter of Proposed New 35 Ill. Adm. Code 217, Subpart W

The suggestion that existing plants are "losing allowances" suggests that they own or have a right to the allowances. This is incorrect. The rule clearly states that allowances are not a property right. The allowances are created by the Federal and State governments as a mechanism to provide clean air at the lowest cost to consumers. They represent the citizen/consumers rights to clean air and should be allocated in the manner which best accomplishes this goal. They certainly do not belong to existing power plants as a reward for their past pollution of the environment.

The model rule sets a 5 percent new source set aside for the initial period to cover all of the new sources that come on line between 1995 and 2003. There is a 2 percent per year set aside for subsequent annual reallocations. Since the subsequent reallocations in Subpart W take place only every two years, the set aside should be increased to at least 4 percent. Due to the high growth in Illinois, it would be better to maintain the 5 percent set aside. There is no risk to setting a higher level. If the growth does not materialize, the unused set aside allowances will simply be allocated to existing sources. On the other hand, if the growth is needed to support Illinois' economy, the availability of set asides will be assured.

In summary, there are several aspects of the fixed/flex approach that will not achieve emissions reductions in the state of Illinois in an equitable or cost-effective manner:

- The setting aside of a fixed portion of the allowances for existing plants.
- The allocation of allowances to new sources based on their very low permitted emission levels rather than at the same level used for existing sources.
- The new source set aside is not granted freely to new sources but is made available as a pool of allowances to be purchased at market prices.
- The new source set aside is reduced to two percent, even though the reallocation period is longer than the one-year reallocation recommended in the EPA model rule.

IV. Negative Impacts of Subpart W

The fixed portion of the allocation constitutes an anticompetitive grant of economic value to the existing plants. This subsidizes continued greater operation of higher emitting plants. Since the overall emissions are capped, the plants must invest in pollution control equipment. Increased operation of the old plants means higher control costs, which are passed on to the public. By subsidizing the operation of the old plants, the fixed/flex approach increases the cost of the program to the public. The new plants, on the other hand, have already invested in clean equipment. Transfer of generation from the old plants to the new plants would decrease the future control costs for the old plants and reduce the overall cost to the public.

The allocation to new sources based only on their low permitted levels denies them any value in the trading program for their low emissions. This reduces the effectiveness of the trading program in reducing the program cost. It also makes Illinois less attractive as a site for new

clean, generation. Without a reliable power supply, Illinois is a less attractive place for new business and new economic growth.

Illinois has recently gone through a long process of restructuring the electric generating sector. A major goal of this effort was to create open competition among electric generators. By creating a vested interest for older power plants, this rule nullifies some of the value of that process. It slows the growth of competitive power and reduces the potential cost savings and reliability improvements for Illinois consumers.

Charging new sources for new source set asides exacerbates the economic disincentives for new, clean power. It has been suggested that this policy is a logical extension of past programs such as the SO₂ trading program or the new source offset policy. However, the SIP call is a new program that was designed by the EPA to include new source set asides at no charge. Adding a charge for allowances is a misapplication of the concept that substantially detracts from the value of the program.

V. Recommendations

In order to encourage the growth of clean, efficient power generation in Illinois, provide the open competition that is contemplated by electric restructuring in Illinois and minimize the cost of the program to Illinois citizens, Enron recommends that the allocation process of Subpart W be substantially restored to the provisions of the EPA model rule including:

- Allocation to all sources based on actual heat input during the appropriate historical period.
- Allocation to all sources at the same rate of 0.15 lb/MMBtu.
- New source set asides be distributed free of charge like other allowances.
- The new source set aside level should be maintained at 5 percent throughout the program.

These changes will allow the trading program to function properly and encourage the growth of clean, efficient power generation that can provide the electricity needed to support a growing Illinois economy. Enron Corp appreciates the opportunity to provide input on this important topic, and we would be pleased to answer any questions the Pollution Control Board may have regarding our comments.