



NORTHEAST STATES FOR COORDINATED AIR USE MANAGEMENT (NESCAUM)

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NEW YORK DIVISION OF AIR RESOURCES
RHODE ISLAND DIVISION OF AIR RESOURCES
VERMONT AIR POLLUTION CONTROL DIVISION

TO: All Interested Parties
FROM: Jason Grumet, Executive Director
DATE: July 5, 1995
RE: Information on the Emission Reduction Credit Demonstration Project

Over the past two years, a diverse group of private companies, environmental and public health groups, and state regulatory agencies have participated in the NESCAUM/MARAMA Emission Reduction Credit Demonstration Project -- a public-private partnership to clean up the air, lower the cost of compliance and reduce the regulatory burden associated with implementing the Clean Air Act Amendments of 1990 (the Act). The results of the project have become the centerpiece of the U.S. Environmental Protection Agency's (EPA's) efforts to reform implementation of the Act.

As a corporation with facilities located in the Ozone Transport Region, you may have an interest in participating in this ongoing, innovative effort to harness market forces to meet the regulatory requirements of the Act. Accordingly, I am pleased to enclose several items which will familiarize you with the Demonstration Project:

- Fact Sheet on the Demonstration Project
- Executive Summary from the Final Report of the second phase of the Demonstration Project

The Fact Sheet includes a list of strategies that industry participants have implemented to generate emission reduction credits as well as a list of proposed uses of these credits. I think the Fact Sheet and the Executive Summary will give you a sense of both the intellectual challenges faced by the participants and the rigorous technical scrutiny applied to the implemented emission reduction strategies. The high quality of the protocols developed for each strategy is one of the primary reasons the Demonstration Project has been able to demonstrate that voluntary emission reductions by industry -- with the cooperation and peer review of regulators and environmental/public health advocates -- can be appropriately quantified to contribute to reducing air pollution and improving public health.

Current Demonstration Project participants expect that the third phase of the Demonstration Project will achieve a similar level of quality and rigor. As a result, participation in the third phase will require that one or more people from your organization be involved in meetings of participants (averaging one every six weeks to two months) and periodic conference calls (averaging one to two hours every week).

NESCAUM/MARAMA have obtained a grant from EPA to cover some of the project costs, but, based on past project experience, we anticipate that additional contributions from private sector project participants will be needed. These funds would be used to cover necessary and appropriate

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project-related expenses which participants agree are to the overall benefit of the project. These expenses would include, but may not be limited to:

- 1) Support for the project synthesizer to develop summaries of all meetings and conference calls. Other duties would include meeting planning, drafting of position papers, an interim report and a final report -- all of which would be reviewed and finalized by participants in the third phase of the Demonstration Project.
- 2) Technical support to non-profit participants (such as the Conservation Law Foundation and America Lung Association) to ensure that they have the necessary technical assistance.
- 3) Travel support for state agency participants.

We estimate that approximately \$300,000 will be needed to meet project costs over the next 12 months. This amount is expected to be generated through private sector participant contributions proportional to company size.

We encourage you to review your company's operations to determine if you are a candidate for emission reduction credit creation or use. If so, we would like to hear about actions your company could take to help reduce ozone pollution through either traditional or innovative approaches to the creation and use of emission reduction credits. If you are interested in speaking with one of the stakeholders, the following stakeholder representatives have volunteered to address questions about their participation in the Demonstration Project:

Eric Svenson, Public Service Electric & Gas, (201) 430-5857
Dorothy Bowers, Merck & Co., (908) 423-6860
Robert Russell, Conservation Law Foundation, (617) 350-0990

If you have any questions regarding the Demonstration Project, please call me or Charla Rudisill at the NESCAUM office.

NESCAUM/MARAMA EMISSION REDUCTION CREDIT DEMONSTRATION PROJECT

Fact Sheet

Purpose of the Project: The NESCAUM/MARAMA ERC Demonstration Project was initiated as a forum for rethinking federal air emission trading policy in an effort to make emissions trading an effective tool for achieving the goals of the Clean Air Act Amendments of 1990 faster and more efficiently than could otherwise be achieved under traditional command-and-control regulations.

Scope of the Project: The NESCAUM/MARAMA ERC Demonstration Project is unique in its commitment to develop insights into emission reduction trading policy through the review of actual emission reduction creation strategies, trades, and uses proposed by project participants. The Demonstration Project also is unique in its commitment to a consensus-based review process involving regulators, environmentalists, and members of the business community.

Structure of the Project: Thus far, the Demonstration Project consists of two phases. The first phase, conducted in 1993, developed the principles of discrete emission reduction creation through the review of actual emission reduction creation strategies. Phase II--the subject of the recently released Demonstration Project report--examines principles of discrete emission reduction trading and use through the review of proposed trades and uses.

A third and final phase, devoted to assessing new emission reduction creation strategies and uses and trades proposed during Phase II and assisting EPA in identifying and resolving issues associated with the promulgation of a generic open-market trading rule, is anticipated for the summer and fall of 1995.

Project Participants: To date, there have been a total of 37 participants in the ERC Demonstration Project. These participants include corporations, environmental/public health organizations and state regulatory agencies, including a majority of the state environmental agencies within the Ozone Transport Region. Although not formal participants, staff from EPA offices in Washington, D.C., Research Triangle Park, North Carolina, and several other regional EPA offices offered informal guidance and feedback on Demonstration Project ideas. A full list of Demonstration Project participants may be found in Attachment A.

Emission Reduction Strategies Reviewed by the Project: Over the course of the first two phases of the ERC Demonstration Project, participants reviewed a total of 24 emission reduction creation strategies. Of the 24 strategies, 14 involve stationary sources and 10 involve mobile sources. Of the 14 stationary source strategies, 11 generate reductions in oxides of nitrogen (NO_x) and three generate reductions in volatile organic compounds (VOCs). Of the 10 mobile source strategies, nine generate VOC reductions and six generate NO_x reductions. A chart listing each reduction strategy may be found in Attachment B.

Emission Reduction Trades and Uses Under Review by the Project: Over the course of the first two phases of the ERC Demonstration Project, participants received proposals for 12 discrete emission reduction trades and 13 discrete emission reduction use strategies. Of the 12 proposed discrete reduction trades, 10 involve the exchange of NO_x reductions and two involve the exchange of VOC reductions. Six of the 12 trades are interstate trades. A chart listing each trade and use may be found in Attachment C.

Accomplishments: Since its inception in June 1993 ERC Demonstration Project participants have:

- Achieved over 8,000 tons of NO_x reductions and 300 tons of VOC reductions during the ozone season, with an additional 1,659 tons of NO_x reductions achieved outside of the ozone season (May 1-September 30). None of these reductions were required by any current federal or state law or regulation.
- Reviewed and endorsed technical drafts of protocols for creation of discrete emission reductions from both mobile and stationary source strategies.
- Proposed the use of reductions identified through the Demonstration Project to meet NO_x RACT and VOC RACT obligations for over 30 sources in the coming years.
- Discovered signs that a market for discrete emission reductions exists. Surplus NO_x reductions generated during the summer of 1993 are currently being offered for \$750-\$1,000 a ton. Discrete VOC emission reductions generated during the summer of 1993 and 1994 are currently being offered for \$2,000-\$2,500 a ton. Use of discrete emission reductions for compliance with federal or state emission requirements may save participating Demonstration Project companies anywhere from 50 to 500 percent of the cost of employing in situ emission control technology.
- Established procedures for the allocation of interstate discrete emission reductions generated by mobile or stationary source strategies with a regional impact.
- Reviewed a model private registry for tracking the creation, transfer and use of discrete emission reductions.
- Achieved basic consensus about the near term structure of an open-market trading system that can become effective now.

About the Sponsors: The Northeast States for Coordinated Air Use Management (NESCAUM) is an association of state air quality directors from each state in New England, New York, and New Jersey.

The Mid-Atlantic Regional Air Management Association (MARAMA) is an association of state air quality directors from Pennsylvania, New Jersey, Delaware, Maryland, Virginia, North Carolina, and the District of Columbia.

NESCAUM initiated the ERC Demonstration Project in 1993. MARAMA became an official sponsor of the ERC Demonstration Project in 1994.

Emission Reduction Credit Demonstration Project

Participants

**American Lung Association of New Jersey
Atlantic Electric
Boston Gas
Boston Park Plaza Hotel and Towers
Chevron Company
Clean Air Action Corporation
Clean Air Council
Coalition for Gas-Based Environmental Solutions
Connecticut Department of Environmental Protection
Conservation Law Foundation
Hoffmann-La Roche
Maine Department of Environmental Protection
Massachusetts Executive Office of Economic Affairs
Massachusetts Executive Office of Environmental Affairs
Massachusetts Department of Environmental Protection
Massachusetts Division of Energy Resources
MASCO
Merck & Co., Inc.
Mid-Atlantic Energy Project
MARAMA
New England Electric System
New Hampshire Audubon Society
New Jersey Department of Environmental Protection
New York Gas Group
New York State Department of Environmental Conservation
New York State Office of Energy
NESCAUM
Northeast Utilities
Pennsylvania Department of Environmental Resources
PECO Energy Company
The PENJERDEL Council
Pennsylvania Resources Council
Public Service Electric & Gas
Sun Company
SYCOM Enterprises
Texaco
Virginia Department of Environmental Quality**

DISCRETE EMISSION REDUCTION CREATION STRATEGIES

<i>Company (State in which reduction occurred)</i>	<i>Description</i>
Atlantic Electric (NJ)	Applied selective non-catalytic reduction (SNCR) technology to a electricity generating unit. Reduced 295 tons of NO _x , non-ozone season, 1993/94
Boston Park Plaza Hotel & Towers (MA)	Implemented a demand-side management strategy by installing highly energy-efficient windows throughout the hotel. Reduced 0.12 tons of NO _x , ozone season, 1993.
Chevron Company (NJ)	Instituted an enhanced leak detection and repair program to track and repair leaks in pumps and valves to attain leak levels below what is currently required by state regulations. Reduced 0.9 tons of VOCs, ozone season, 1993.
Clean Air Action Company (PA, NJ)	<p>1. Undertook gasoline Reid vapor pressure reduction including the estimation of the emissions improvement during distribution and storage in addition to reduced vehicle emissions. Reduced 21.48 tons of VOCs, ozone season, 1993 and 0.44 tons of VOCs, ozone season, 1994.</p> <p>2. Designed a strategy in 1993 to create ERCs from an automated toll-collection system. Not implemented.</p>
Hoffmann-La Roche (NJ)	Implemented a leak detection and repair program involving fugitive-emissions monitoring and capture. Reduced 44.5 tons of VOCs, ozone season, 1993.
MASCO (MA)	Established acceptable documentation for a vanpool/carpool system to identify net emission reductions. Reduced 0.2 tons of NO _x and 0.2 tons of VOCs, ozone season, 1993.

Creation Strategies (con't)

<i>Company (State in which reduction occurred)</i>	<i>Description</i>
Merck & Company, Inc. (NJ)	Implemented several emissions reduction initiatives, including process chemistry changes, fugitives monitoring and spot repair, solvent substitution, and installed process monitoring and vapor recovery equipment in most of its manufacturing operations. Reduced 2 tons of NOx, ozone season, 1993.
New England Electric System (MA)	<p>1. Undertook demand-side management initiatives that included residential, commercial and industrial energy savings. Reduced 73 tons of NOx, ozone season, 1993 and 103 tons of NOx, non-ozone season, 1993.</p> <p>2. Applied low-NOx burners with over-fired air to reduce NOx emissions from an electric generating unit. Reduced 360 tons of NOx, ozone seasons, 1994 and 1995; and 1,260 tons of NOx, non-ozone seasons, 1994 and 1995.</p>
New York Gas Company (NY)	Converted heavy-duty diesel vehicles to run on natural gas in 1994. Reductions of NOx and VOCs not quantified.
PSE&G (NJ)	<p>Implemented six emission reduction strategies:</p> <p>1. Utility seasonal fuel-switch on 2 units with CEMS. Reduced 1,700 and 1,900 tons of NOx, ozone season. 1993.</p> <p>2. Utility seasonal fuel switch without CEM. Reduced 2,724 tons of NOx, ozone season, 1994.</p> <p>3. Utility selective non-catalytic reduction (SNCR). Reduced 454 tons of NOx, ozone season, 1993.</p> <p>4. Utility selective catalytic reduction (SCR). Reduced 1,200 tons of NOx, ozone season, 1994.</p> <p>5. A lawnmower scrappage program. Reduced 0.003 tons of VOCs, ozone season, 1993.</p> <p>6. A 150 MW energy conservation program (DSM). Reduced 47.3 tons of NOx, ozone season, 1993.</p>

Creation Strategies (con't)

<i>Company (State in which reduction occurred)</i>	<i>Description</i>
Sun Company (PA)	<p>Completed three strategies:</p> <ol style="list-style-type: none"> 1. Vehicle scrappage program. Reduced 3.68 tons of NOx and 13.49 tons of VOCs, 1993. 2. Reduced RVP gasoline. Reduced 74.8 tons of VOCs, ozone season, 1993. 3. Remote sensing and repair of high-emitting light-duty vehicles in 1994. Reduced 3.4 tons of NOx, 14.4 tons of VOCs and 258.1 tons of CO over 2 years.
SYCOM Enterprises (NJ)	Instituted demand-side management on electricity customers in New Jersey. Reduced 1.34 tons of NOx, ozone season, 1994, and 1.41 tons of NOx, non-ozone season, 1994
Texaco (NJ)	Produced cleaner gasoline for use by motorists in 1994. Reduced tons of NOx pending quantification.

PROPOSED DISCRETE EMISSION REDUCTION TRADES AND USES

Intrastate Trades

<i>Trade</i>	<i>Pollutant</i>	<i>Quantity</i>	<i>Term</i>	<i>Use</i>
PSE&G to Merck (NJ)	NOx	75 tons a year	4 years	NOx RACT compliance for two powerhouse boilers
Clean Air Action Corporation to MAFCO (NJ)	NOx	30 tons a year	4 years	NOx RACT compliance on process steam boilers; winter peaking
Clean Air Action Corporation to Getty (NJ)	VOC	7.06 tons	5 days	Compliance with New Jersey RVP requirements
Clean Air Action Corporation to Homasote (NJ)	NOx	14 tons a year	4 years	NOx RACT Compliance
Clean Air Action Corporation to Homasote (NJ)	VOC	2 tons a year	4 years	VOC RACT Compliance
Clean Air Action Corporation to Vineland	NOx	60 tons	1 year	NOx RACT Compliance for utility boilers

Proposed Trades and Uses (con't.)

Interstate Trades

<i>Trade</i>	<i>Pollutant</i>	<i>Quantity</i>	<i>Term</i>	<i>Use</i>
Clean Air Action Corporation to Aetna (NJ to CT)	NOx	30 tons a year	4 years	NOx RACT compliance for emergency generation & peak shaving
Clean Air Action Corporation to CMEEC (NJ to CT)	NOx	10 tons a year	4 years	NOx RACT compliance for peak generation units
Clean Air Action Corporation to CRRA (NJ to CT)	NOx	400 tons a year	4 years	NOx RACT compliance for municipal solid waste incinerator and compliance margin for NOx RACT compliance
Clean Air Action Corporation to Northeast Utilities (NJ to CT)	NOx	100 tons a year	5 years	55 tons initially for NOx RACT compliance on peak generation units in 20 locations
Clean Air Action Corporation to Pfizer (NJ to CT)	NOx	325 tons a year	1 year	Delayed NOx RACT compliance on three process steam boilers
Clean Air Action Corporation to Pfizer (NJ to CT)	NOx	50 tons a year	4 years	NOx RACT compliance assurance margin on six process steam boilers

EXECUTIVE SUMMARY

This report summarizes the results of the NESCAUM/MARAMA Emission Reduction Credit (ERC) Demonstration Project.* The purpose of this report is to provide information to companies and states interested in the development of market-based emission reduction programs, offer insights to the United States Environmental Protection Agency (EPA) as it drafts a generic emission reduction trading rule, and share information with other regional projects and programs studying emission reduction trading as a tool for expediting attainment of the National Ambient Air Quality Standard for ozone.

Background

Harnessing market behavior to achieve federal air quality objectives is an idea as old as the Clean Air Act (CAA) itself. The reason is simple. Traditional command-and-control regulation sets a single standard and treats all sources subject to the standard the same. Sources with high compliance costs must achieve the same level of reductions as sources with low compliance costs. This is an inefficient result, creating hardship for some sources while failing to capture cost-effective reductions from other sources. Too often a source's compliance difficulties require regulators to grant case-by-case modifications or exemptions from emission standards. This provides regulatory flexibility at the expense of the environment.

In contrast, market-based regulation capitalizes on this compliance cost differential by allowing the sources with higher compliance costs to purchase reductions from the sources

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with lower compliance costs. The net effect is the same level of overall air quality benefit but for a smaller total cost - or an even greater air quality benefit for the same cost - than if the high compliance cost source were required to install control technology. The regulatory structure becomes more cost-effective and flexible without harm to the environment. These benefits become increasingly desirable as standards become tighter and compliance becomes more difficult.

Traditional Trading Paradigms: Emissions Averaging and Closed Market System

To date, emissions averaging and closed market systems are the two most common forms of market-based regulatory programs. Emissions averaging - where the average of emission rates of two or more commonly-owned sources equals the rate of emissions that would have occurred if each source complied with its original emission limit - is summarized in EPA's 1986 Emissions Trading Policy Statement (ETPS). In closed market systems, rate-based emission limitations on individual sources are replaced by a mass-based emission limitation or "cap" on a category of sources. Emission allowances equalling the total amount of emissions allowed under the cap are created and allocated by proportional distribution or auction to each source subject to the cap. At the end of each year, each source must possess a sufficient number of allowances to cover its emissions during that year. Sources may obtain allowances by generating excess emission reductions or by purchasing allowances from sources that have made excess reductions. The federal Acid Rain Program is an example of a closed market system.

The Demonstration Project Paradigm: An Open Market

The NESCAUM/MARAMA ERC Demonstration Project was initiated as a forum for rethinking emission reduction trading policy - particularly the ETPS - in an effort to make emission reduction trading an effective tool for achieving the goals of the CAA Amendments of 1990 faster and more efficiently than could otherwise be achieved under traditional command-and-control. The project has evolved into a forum for developing and testing principles of a new form of market-based program: an open market trading system.

An open market trading system is built upon five insights:

- 1) Quantification of emission reductions produced by an emission reduction strategy is simpler, more accurate, and more certain if performed retrospectively rather than prospectively, as is typically done under the ETPS.
- 2) Retrospective quantification of emission reductions enables a source to generate creditable emission reductions without the need for a permit modification or other federally-enforceable commitment on creation.
- 3) Rate-based "continuous" emission reductions common under the prospective procedures in the ETPS have less environmental integrity than the quantification of reductions into mass-based "discrete" units of emission reductions.
- 4) The combination of discrete emission reductions and intertemporal trading (the creation of reductions in one ozone season or year for use in a subsequent ozone season or year) provides sources with an incentive to implement short term emission reduction strategies which are otherwise not practicable under the regulatory restrictions associated with an emissions averaging program.
- 5) In particular, intertemporal trading provides sources with an incentive to undertake early and incremental reductions, which can be done with minimal additional cost but have a real effect on reducing lifetime exposure to ozone by reducing concentrations of ozone precursor emissions. Intertemporal trading enables experimentation with reduction strategies which may lead to innovative emission reduction strategies.

Building upon these concepts, Demonstration Project participants envision a trading system in which a source may meet a rate-based emission limitation with a mass-based discrete emission reduction. The amount of reductions required will equal the emission reductions that would otherwise be achieved by installation and operation of control equipment. Discrete reductions could be banked for future use, consistent with regulatory safeguards to ensure that shifting emissions into the future would not upset state plans to achieve reasonable further progress towards attainment of the ozone standard or state plans to achieve attainment.

In contrast to a closed market system, participation in an open market system is voluntary, a function of a source's decision-making about cost-effective compliance rather than a regulatory mandate. In contrast to emission averaging, an open market system uncouples the creation of reductions from the use of reductions, enabling a more dynamic market to take hold which encourages the creation of additional reductions.

About the Demonstration Project

The NESCAUM/MARAMA ERC Demonstration Project is unique in its commitment to develop insights into emission reduction trading policy through the review of actual emission reduction creation strategies, trades, and uses proposed by project participants. The Demonstration Project also is unique in its commitment to a consensus-based review process involving regulators, environmentalists, and members of the business community.

Thus far, the Demonstration Project consists of two phases. The first phase, conducted in 1993, developed the principles of discrete emission reduction creation through the review of actual emission reduction creation strategies. Phase II - the subject of this report - examines principles of discrete emission reduction trading and use through the review of proposed trades and uses. A third and final phase, devoted to assessing the trades and uses set into motion during Phase II and assisting EPA in identifying and resolving issues associated with the promulgation of a generic open market trading rule, is anticipated for the summer and fall of 1995.

At the start of each phase of the Demonstration Project, participants sign an agreement confirming their individual commitment to the basic objectives of the project. This "Agreement Among Participants" emphasizes that the project is a voluntary *demonstration* project where participants propose and review emission reduction strategies, trades, and uses without preconceptions or preconditions about the results. *Signatories understand that project conclusions are not to be mistaken for statements of policy by any agency, corporation, organization, or association participating in the project. Air quality policy can only be established through appropriate legislative and administrative procedures in each state, consistent with the federal CAA.* Results from the Demonstration Project may inform future legislative and administrative efforts to implement federal and state air quality requirements;

however, Demonstration Project conclusions, recommendations, and insights do not predetermine the outcome of those efforts.

The Participants

To date, a total of 37 corporations, state regulatory agencies, and environmental/public health organizations have participated in the Demonstration Project, including a majority of the state environmental agencies within the Ozone Transport Region. Although not signatories to the Agreement Among Participants, EPA headquarters in Washington, D.C. and Research Triangle Park, North Carolina, and several regional EPA offices participated in Demonstration Project meetings and conference calls, offering informal guidance and feedback on Demonstration Project ideas.

The Strategies

Over the course of the first two phases of the Demonstration Project, participants reviewed a total of 24 emission reduction creation strategies, and received proposals for 12 discrete emission reduction trades and 13 discrete emission reduction use strategies. Of the 24 creation strategies, 14 involve stationary sources and 10 involve mobile sources. Of the 14 stationary source strategies, 11 generate reductions in oxides of nitrogen (NO_x) and three generate reductions in volatile organic compounds (VOCs). Of the 10 mobile source strategies, nine generate VOC reductions and six generate NO_x reductions. Of the 12 proposed discrete emission reduction trades, 10 involve the exchange of NO_x reductions and two involve the exchange of VOC reductions. Six of the 12 proposed trades are interstate trades.

Demonstration Project Accomplishments

Since its inception in June, 1993, Demonstration Project participants have:

- * Achieved over 8,000 tons of NO_x reductions and 300 tons of VOC reductions during the ozone season, with an additional 1,659 tons of NO_x reductions achieved outside of

the ozone season (May 1 - September 30). None of these reductions was required by any current federal or state law or regulation.

- * Discovered signs that a market for discrete emission reductions exists. Surplus NO_x reductions generated during the summer of 1993 are currently being offered for \$750 - \$1,000 a ton. Discrete VOC emission reductions generated during the summer of 1993 and 1994 are currently being offered for \$2,000 - \$2,500 a ton. Use of discrete emission reductions for compliance with federal or state emission requirements may save participating Demonstration Project companies anywhere from 50 to 500% of the cost of employing *in situ* emission control technology.
- * Proposed the use of reductions identified through the Demonstration Project to meet NO_x RACT and VOC RACT obligations for over 30 sources in the coming years.
- * Achieved consensus that "real, quantifiable, and surplus" are the three critical criteria for creation of useable emission reductions.
- * Reviewed and endorsed technical drafts of protocols for creation of discrete emission reductions from both mobile and stationary source strategies.
- * Established procedures for the allocation of interstate discrete emission reductions generated by mobile or stationary source strategies with a regional impact.
- * Reviewed a model private registry for tracking the creation, transfer, and use of discrete emission reductions.
- * Reviewed model reporting forms for use in conjunction with the creation, transfer, and use of discrete emission reductions.
- * Assisted in the development of model single-source state implementation plan (SIP) revisions to facilitate the use of discrete emission reductions as a compliance alternative under current EPA policy, in the absence of an EPA-approved, state-adopted emission reduction trading rule, or a modification of EPA enforcement policy.

- * Achieved basic consensus about the near-term structure of an open market trading system that can become effective now.