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Colin McConnaha
Manager, Office of Greenhouse Gas Programs
Oregon Department of Environmental Quality
Via email to CapandReduce@deq.state.or.us

Re: Comments on Climate Protection Program Rulemaking Advisory Committee Meeting No. 2 on Flexibility Mechanisms and Point-of-Regulation

Dear Mr. McConnaha:

The Green Energy Institute at Lewis & Clark Law School is a nonprofit energy and climate law and policy institute within Lewis & Clark's top-ranked environmental, natural resources, and energy law program. We greatly appreciate the opportunity to participate in the Rulemaking Advisory Committee (RAC) for the Department of Environmental Quality's (DEQ) Climate Protection Program, and respectfully submit these comments on issues relating to flexibility mechanisms and appropriate points of regulation under the program.

To achieve the science-backed reductions in greenhouse gas (GHG) emissions called for under Oregon law and Governor Brown's Executive Order 20-04, Oregon must make swift and steady progress to decarbonize the vast majority of its economy by 2050. The Climate Protection Program can help drive the state's progress in achieving its climate goals by decreasing fossil fuel consumption and spurring investments in emissions-free technologies and infrastructure. The four flexibility mechanisms discussed in the second RAC meeting—compliance instrument banking, compliance instrument trading, alternative compliance options, and multi-year compliance periods—each have the potential to support the program's goals of reducing GHG emissions while promoting equity and containing costs. However, if the program provides regulated entities with too much compliance flexibility, these mechanisms could also delay or deter essential decarbonization efforts and investments. It is therefore imperative that the program balances the desire to provide flexibility with the need to maintain progress in reducing emissions and advancing an equitable transition to a decarbonized economy.

Flexibility mechanisms can help support the program's objectives by enabling regulated entities to make adjustments to their compliance activities in response to uncertainty or variability outside of their control. Mechanisms like compliance instrument banking and trading may encourage regulated entities to proactively reduce emissions more quickly than necessary to ease future compliance obligations or offset compliance costs. Multi-year compliance periods could

give regulated entities the flexibility to adjust the pace of their emissions reductions from year to year in response to fluctuating market dynamics. However, the flexibility mechanisms' capacity to mitigate risk and address uncertainty is largely dependent on regulated entities engaging in rational and responsible decision-making. If regulated entities instead use the flexibility mechanisms to avoid or delay compliance efforts or investments, it could undermine the program's potential to achieve equitable and economical emissions reductions. This outcome would expose the general public and impacted communities in particular to substantial risk and uncertainty. In designing flexibility mechanisms, DEQ should therefore strive to balance and mitigate risk and uncertainty for regulated entities, impacted communities, and the general public, and should avoid establishing mechanisms that could diminish or undermine the program's effectiveness. Above all, any mechanisms that aim to control costs and/or increase flexibility for regulated entities must conform to a pathway that will enable Oregon to achieve its statewide climate targets.

Our comments respond to the specific discussion questions raised during the Climate Protection Program's second RAC meeting. Part I responds to DEQ's discussion question regarding the flexibility mechanisms' potential to effectively achieve the program's goals to reduce emissions, contain costs, and support equity. Part II discusses approaches for structuring alternative compliance options (ACOs) to drive investments that reduce emissions while benefiting impacted communities. Part III describes some of the implications of establishing multi-year compliance periods (MYCPs). Part IV responds to DEQ's discussion question regarding appropriate point of regulation for emissions from direct natural gas use.

I. Flexibility Mechanism Potential to Support Emissions Reductions, Contain Costs, and Achieve Equitable Outcomes

Discussion Question 1: *Which flexibility mechanism(s) do you find the most effective for supporting emissions reductions, containing costs, and equitable outcomes? Which do you find the least effective in achieving these goals? Why?*

The flexibility mechanisms proposed by DEQ—compliance instrument banking and trading, alternative compliance options, and multi-year compliance periods—have varying and potentially significant implications for reducing emissions, containing costs, and promoting equitable outcomes under the program. The following subsections focus on the program's three primary objectives to reduce emissions, contain costs, and promote equity, and discuss how the various flexibility mechanisms may impact these three objectives.

A. Reducing Emissions

Alone, the flexibility mechanisms are unlikely to have a meaningful impact on the emissions reduction potential of the program. These mechanisms will generally only provide emissions benefits if DEQ and the EQC establish ambitious emissions caps for the program. Some of the flexibility mechanisms could potentially help incentivize early emissions reductions, though outside variables and market dynamics could impact this outcome. At the same time, too much compliance flexibility could impede emissions reductions, particularly if there is an abundance

of low-cost compliance instruments available for purchase. The following subsections discuss some of the emissions reductions implications of banking, trading, alternative compliance options, and multi-year compliance periods.

1. Banking and Emissions Reductions

Over the lifetime of the program, compliance instrument banking likely will not result in emissions reductions beyond those required under the cap. However, banking could encourage some regulated entities to maximize emissions reductions in the early years of the program to offset their compliance obligations in later compliance periods. From a climate standpoint, early emissions reductions are preferable to later emissions reductions, so banking could potentially provide net benefits to the state if it effectively incentivizes early action.

However, banking—and particularly banking provisions that allow regulated entities to bank an unlimited number of compliance instruments for an indefinite amount of time—would also make the program vulnerable to error and uncertainty. If DEQ over-allocates compliance instruments to any regulated entities, or if a regulated entity reduces its emissions in response to external factors outside of the source's control, such as unexpected weather conditions or an economic disruption, those entities could bank their excess compliance instruments and delay making actual emissions reductions in later compliance periods. Banking therefore carries a significant risk of deterring emissions reductions in later compliance periods, when the impacts of climate change are more severe.

If unlimited banking is permitted to protect regulated entities from uncertainties, the program should not include additional cost containment mechanisms to protect regulated entities if unexpected events occur. If regulated entities know that additional compliance forgiveness is available if compliance costs exceed a certain threshold, unlimited banking could serve to negate the need for future emissions reductions without meaningfully incentivizing early reductions.

We also encourage DEQ to consider establishing limits on banking that would be triggered under certain circumestances. For example, DEQ should consider creating an automatic adjustment mechanism that would trigger banking restrictions if there is a substantial over-allocation of compliance instruments, or if external market dynamics or unexpected weather conditions cause emissions to signficantly decrease during a compliance period. If these threshold conditions occur, the program could automatically impose limits on the number of compliance instruments entities may bank and/or assign expiration dates for any instruments banked during the compliance period.[1] DEQ should also consider prohibiting the banking of compliance instruments received through over-allocation by the agency, particularly if the over-allocation was influenced by inaccurate baseline emissions data.[2] Finally, we want to reiterate a

[1] We previously made this recommendation in our comments on the program's illustrative scenarios. Green Energy Institute Comments on Cap and Reduce Illustrative Scenarios at 5–6, Dec. 9, 2020, *available at* https://law.lclark.edu/live/files/31435-c-and-r-illustrative-scenarios-gei-comments.

[2] Green Energy Institute Comments on Cap and Reduce Technical Workshop 5: Cost Containment, Oct. 2, 2020, *available at* https://law.lclark.edu/live/files/31437-c-and-r-cost-containment-gei-comments.

recommendation we raised in previous comments and encourage the program rules to clearly specify that compliance instruments are not property rights.[3]

2. Trading and Emissions Reductions

Similarly to banking, trading will likely not result in additional emissions reductions over the lifetime of the program, but could potentially encourage near-term reductions by sources that cost effectively reduce emissions in early compliance periods. However, trading could also make the program vulnerable to over-allocations or over-abundances of compliance instruments resulting from external pressures. But while banking could potentially compromise the integrity of the program in future compliance periods, unrestricted trading could deter emissions reductions at any time. As the supply of marketable compliance instruments increases, the price for those instruments will decrease. If it is more economical to purchase compliance instruments than it is to deploy emissions reduction technologies or practices, regulated entities will choose trading over physical compliance. Trading could therefore deter or delay investments in technologies or efficiencies that would otherwise reduce emissions.

To discourage regulated entities from delaying investments, DEQ should consider limiting the number of purchased compliance instruments entities may use during a compliance period. Alternatively, DEQ could consider establishing an automatic adjustment mechanism that imposes restrictions on trading if the supply of compliance instruments available for purchase exceeds a certain threshold.[4]

3. Alternative Compliance Options and Emissions Reductions

Compliance activities that achieve real, measurable, verifiable, additional, and permanent reductions in anthropogenic GHG emissions will provide the greatest long-term emissions reductions benefits under the program. Alternative compliance options (ACOs) could further the emissions reduction potential of the program by providing a mechanism for regulated entities to invest in emissions reduction programs, projects, and technologies that reduce fossil fuel reliance and consumption at the consumer level. Unlike the other flexibility mechanism, ACOs could potentially drive emissions reductions beyond those required under the cap by increasing consumer demand for zero-emissions vehicles and appliances.

A large and growing portion of Oregon's GHG emissions are produced by decentralized sources—internal combustion engine (ICE) vehicles and other fossil fueled modes of transportation, and homes and businesses with natural gas-fired heating and cooking systems—that will only be effectively reduced through consumer action. To reach our 2050 climate targets, Oregonians will need to transition to zero-emissions vehicles and replace gas-fired furnaces and stoves with efficient electric alternatives. By regulating GHG emissions from transportation fuel and natural gas suppliers, the Climate Protection Program can help build momentum to drive

[3] This clarification would prevent regulated entities from bringing taking challenges against the Department if restrictions are imposed on banking in the future. *See id.* at 4.

[4] We previously made this recommendation in our comments on the program's illustrative scenarios. Green Energy Institute Comments on Cap and Reduce Illustrative Scenarios at 5–6, Dec. 9, 2020, *available at* https://law.lclark.edu/live/files/31435-c-and-r-illustrative-scenarios-gei-comments.

these transitions, but the fuel and gas suppliers will ultimately be responsible for determining how and where emissions get reduced. ACOs provide a mechanism for incentivizing regulated entities to invest in programs and projects that help consumers transition to zero-emissions technologies and infrastructure. Strategic ACO investments also have the potential to produce emissions reductions beyond the scope of the projects themselves by helping create economies of scale for zero-emissions vehicles and appliances and influencing consumer purchasing decisions by normalizing new and unfamiliar technologies.

To achieve the program's equity objectives, ACOs should prioritize projects that measurably reduce emissions of GHGs and provide equitable benefits, such as reductions in co-pollutant emissions, reduced exposure to energy-related cost volatility, or increased employment and job training opportunities, in impacted communities within the state.[5] This limited geographic scope will ensure that Oregon's historically underserved, disadvantaged, and disproportionately vulnerable communities and communities of color benefit from investments in alternative compliance projects and experience improvements in local air quality. If ACOs are subject to those criteria and Oregon-specific eligibility parameters, they could have a meaningful impact on in-state emissions while providing valuable co-benefits for impacted communities.

If, however, regulated entities have the option of purchasing biogenic carbon offset credits as a means of alternative compliance under the program, the integrity of the cap would be put in jeopardy. As we emphasized in our previous comments on DEQ's technical workshop on alternative compliance, biogenic carbon offsets from forestry and land use sequestration projects enable fossil fuel emissions to continue at unabated rates without providing any guarantee that those emissions will be accurately and permanently offset by sequestered carbon.[6] To ensure that the program can and will achieve necessary reductions in anthropogenic emissions, the program should prohibit the use of biogenic carbon offsets for compliance purposes.

4. Multi-Year Compliance Periods and Emissions Reductions

Like banking and trading, multi-year compliance periods (MYCPs) will not likely achieve additional emissions reductions beyond those mandated under the cap. MYCPs could potentially enable some regulated entities to deploy emissions reduction technologies or projects that would be challenging to implement during a single compliance year, such as projects that have extended permitting and development timelines. However, MYCPs assume that most regulated entities will be proactive in their compliance efforts, which may not prove to be the case. Instead, there is a significant risk that MYCPs could encourage regulated entities to take a "wait-and-see" approach to emissions reductions and defer making investments in new technologies in the hope that cheap compliance instruments will be available for purchase in later years of the compliance period. If compliance instruments are not available for purchase, some sources may be unable to meet their compliance obligations. If many regulated entities choose to procrastinate and fail to reduce emissions in the early years of a compliance period, there is a risk that aggregate

[5] The equity benefits and opportunities associated with alternative compliance options are discussed in greater detail in section I.C.3 of these comments.

[6] Green Energy Institute Comments on Cap and Reduce Technical Workshop 3: Alternative Compliance Options, Sept. 10, 2020, *available at* https://law.lclark.edu/live/files/31438-c-and-r-alternative-compliance-option-gei-comments.

emissions could exceed the program cap. If this occurs, we would lose the benefits from any early emissions reductions.

To ensure that sources stay on track to meet their compliance obligations over MYCPs, sources should be required to demonstrate that they can meet a portion of their compliance obligations each year. Moreover, if the program has MYCPs, DEQ should not create any additional mechanisms to provide compliance relief to regulated entities that are unable to achieve their multi-year obligations through direct emissions reductions or compliance instrument trading. In general, compliance periods must be short enough to incentivize early emissions reductions and quickly address and correct noncompliance by any regulated sources or sectors.

B. Cost Containment

The proposed flexibility mechanisms could potentially help contain compliance costs resulting from uncertain events or variables under the program, particularly if regulated entities act rationally and proactively to reduce their risk exposure through early actions and investments. However, as we noted in our introduction, these mechanisms will only achieve their desired effects if they are the *only* cost containment mechanisms available to regulated sources. If additional compliance relief is available to safeguard regulated entities from potential financial impacts, the flexibility mechanisms could actually deter regulated entities from making investments in systems or technologies that would otherwise help further the program's equity and emissions reductions goals. As an overarching principle, the program should prioritize mitigating cost burdens on impacted communities, and impose additional restrictions on flexibility mechanisms that function to reduce compliance costs for regulated entities while increasing risks for impacted communities.

The following subsections discuss some of the cost contaiment implications of banking, trading, alternative compliance options, and multi-year compliance periods.

1. Banking and Cost Containment

Banking has the potential to encourage early and economical emissions reductions by rewarding regulated entities that go beyond their initial compliance obligations. However, banking also has the potential to create economic windfalls for regulated entities that experience reductions in emissions due to external pressures or variables, particularly if those variables only impact specific industries or sectors. For example, unexpectedly mild winter temperatures could lead to reductions in natural gas emissions, leaving gas utilities with an excess of bankable compliance instruments. These banked instruments would then offset some of the utilities' future compliance obligations, which in turn could discourage investments in zero-emissions technologies, such as electric heat pumps in impacted low-income communities. Under this scenario, unlimited banking could expose impacted communities to rising fuel costs and increase rather than mitigate the economic burdens resulting from the energy transition.

To help contain costs for impacted communities in addition to containing compliance costs for regulated entities, DEQ should seriously consider establishing limits on banking or creating an

automatic adjustment mechanism that would restrict regulated entities from banking compliance instruments if the program fails to achieve equity-related milestones.

2. Trading and Cost Containment

Trading may have the greatest potential to help contain costs in the program's early compliance periods by incentivizing regulated entities to maximize cost-effective emissions reductions. However, trading will likely encourage entities to pick the lowest-hanging fruit first and pursue strategies that can reduce emissions quickly, cheaply, and easily. From a climate standpoint, this isn't necessarily a bad outcome, because early emissions reductions will provide greater climate benefits than later reductions. But from a cost containment standpoint, it could make it more costly and challenging for regulated entities to reduce emissions in later compliance periods when compliance obligations will be more stringent.

3. Alternative Compliance Options and Cost Containment

With supporting co-benefit eligibility criteria, alternative compliance options have the greatest potential to help contain costs for impacted communities that already face disproportionate energy burdens and are most vulnerable to cost increases associated with the energy transition. As the cap lowers over time, the cost of fossil fuels—and thus the cost of operating vehicles and appliances powered by fossil fuels—will almost certainly rise. Households that transition to electric vehicles and heating systems will be less impacted by the rising cost of gasoline and natural gas, while households that are unable to switch to electric technologies could experience significant financial hardships. ACOs have the potential to mitigate these financial burdens in impacted low-income communities by incentivizing regulated entities to invest in projects that reduce communities' dependence on fossil fuels.

4. Multi-Year Compliance Periods and Cost Containment

The cost containment potential of MYCPs will depend on the actions and behaviors of regulated entities. If a majority of entities choose to delay making investments in emissions reduction strategies in early years in the hope that low-cost compliance instruments will be available for purchase in later years, the surge in demand would likely cause compliance instrument prices to rise, driving up compliance costs for many regulated entities. Alternatively, if there is an abundance of compliance instruments available for purchase in early compliance years, it may be more economical for regulated entities to purchase compliance instruments rather than reduce their physical emissions in later compliance years. Under this scenario, MYCPs could help contain compliance costs in early periods, but could also contribute to cost escalations in later periods as compliance obligations increase and there are fewer compliance instruments available for purchase. In general, MYCPs will be more vulnerable to market speculation than single-year compliance periods, so cost impacts could vary dramatically between different compliance periods.

C. Equitable Outcomes

In general, the flexibility mechanisms will only support the program's equity goals if they effectively incentivize investments in zero-emissions infrastructure and technologies and help advance an equitable energy transition that disproportionately benefits—rather than burdens—impacted environmental justice, BIPOC, and low-income communities across Oregon. Each of the flexibility mechanisms proposed by DEQ have the potential to either advance or impede equitable outcomes under the program. Overall, alternative compliance options have the greatest potential to provide equity benefits, while unrestricted banking and trading of compliance instruments present the most significant equity risks. The following subsections discuss some of the equity implications of banking, trading, alternative compliance options, and multi-year compliance periods.

1. Banking and Equity

Banking has the potential to provide equity benefits under the program, but there are also significant risks that unlimited banking could deter investments in projects or programs that would otherwise benefit impacted EJ communities. Banking enables regulated entities to stockpile compliance instruments for use in later compliance periods, which effectively reduces entities' compliance obligations in future years. If regulated entities generate large quantities of bankable compliance instruments through activities that do *not* provide direct equity benefits for impacted communities (such as investments in new infrastructure or reductions in transportation emissions), those banked instruments will reduce or negate the need to invest in equity-centered emissions reductions in future compliance periods. These equity impacts would be even more pronounced if emissions drop as a result of external events or circumstances, such as an economic recession.

To preserve the incentive to invest in emissions reductions that provide equitable co-benefits in impacted communities, DEQ should consider imposing some limits on banking. For example, the program could impose limits on the number or percentage of compliance instruments regulated entities can bank and/or use in any individual compliance periods. The program could allow unlimited banking of compliance instruments generated through equity-focused emissions reductions, while imposing restrictions on the banking, use, and/or lifespan of other compliance instruments.

2. Trading and Equity

Out of all the flexibility mechanisms proposed by DEQ, compliance instrument trading has the most potential to impede the program's equity objectives by enabling regulated entities to purchase emissions reductions from other sources, rather than physically reduce emissions from their operations or fossil fuel sales. In comparison to Oregon's other GHG-emitting sectors, emissions from the transportation sector present the greatest threat to public health. Emissions from on-road and nonroad mobile sources disproportionately harm environmental justice communities located near highways, ports, rail yards, and other "indirect sources" of air pollution, such as warehouses, freight terminals, and industrial facilities, that operate or attract large numbers of fossil fuel-powered vehicles and engines. By capping and reducing emissions

from transportation fuels on a statewide level, the Climate Protection Program will help reduce harmful co-pollutant emissions of fine particulate matter and other air toxics in EJ communities. However, unrestricted trading of compliance instruments could lose these equity benefits if transportation fuel suppliers choose to purchase compliance instruments instead of pursuing other strategies to reduce gasoline and diesel use across the state.

To promote compliance investments that provide equity benefits in addition to emissions reductions, DEQ should consider imposing some restrictions on compliance instrument trading. For example, if the program limits the number of purchased compliance instruments entities may use to demonstrate compliance or bank for future use, regulated entities will have added incentive to directly reduce emissions or invest in projects that reduce emissions while providing additional equity benefits in impacted communities.

3. Alternative Compliance Options and Equity

ACOs have the greatest potential to provide equitable benefits while also reducing anthropogenic emissions from fossil fuel consumption in Oregon. As we noted in our previous comments on DEQ's cap and reduce program technical workshop on alternative compliance options, a strategically designed, community-driven alternative compliance mechanism could spur investment in just and equitable emissions reduction projects in Oregon's impacted frontline and environmental justice communities.[7]

If ACOs are not permitted under the program, there is a legitimate risk that regulated transportation fuel and natural gas suppliers will increase fuel costs as a means of reducing demand for their products and pass on their compliance costs to consumers. These cost increases would be most pronounced for consumers that remain reliant on fossil fuels, which would disproportionately burden low-income households and individuals that have limited resources to invest in zero-emissions vehicles and appliances. Rising energy costs would make it even more challenging for historically disadvantaged communities to transition to carbon-free technologies.

Under traditional cap-and-trade models, program administrators can raise public revenue from the sale of emissions allowances and then reinvest the revenue into projects and programs that mitigate economic impacts and provide additional benefits in impacted communities.[8] In Oregon, however, state law limits the EQC's authority to raise revenue from air quality programs, which means that the Climate Protection Program has limited potential to raise public funds for emissions reduction projects in impacted environmental justice, BIPOC, and low-income communities.

A well-designed ACO mechanism could help alleviate the program's revenue-raising limitations by incentivizing regulated entities to invest in projects that reduce fossil fuel emissions in impacted communities and help advance a just and equitable energy transition in Oregon. To

[7] Green Energy Institute Comments on Cap and Reduce Technical Workshop 3: Alternative Compliance Options, Sept. 10, 2020, *available at* https://law.lclark.edu/live/files/31438-c-and-r-alternative-compliance-option-gei-comments.

[8] For example, California's cap and trade program has raised billions of dollars to fund emissions reduction projects in environment justice and low-income communities. California Climate Investments, *Cap-and-Trade Dollars at Work,* http://www.caclimateinvestments.ca.gov.

maximize equitable social, economic, and environmental benefits, the ACO mechanism should prioritize investments in projects that accelerate the transition away from fossil fuels in impacted communities and/or provide meaningful and measurable co-benefits in impacted communities, such as reductions in harmful air pollution or increased employment or job training opportunities.

For example, ACO investments could help fund the replacement of fossil fuel vehicles with comparable zero-emissions models, or fund the installation of energy-efficient electric heat pumps in residences in impacted communities. By establishing a strong preference for projects that help impacted communities transition away from fossil fuel-dependent technologies, the ACO mechanism would mitigate risks related to future energy burdens and help ensure that disadvantaged communities at the frontline of the climate crisis are not left behind as Oregon decarbonizes its economy.

4. Multi-Year Compliance Periods and Equity

MYCPs could potentially further the program's equity goals if regulated entities are proactive and use the entirety of the compliance period to deploy infrastructure that has longer development lead times, such as EV charging infrastructure or renewable energy systems. However, MYCPs could also deter equitable outcomes if regulated entities delay making investments in emissions reduction technologies and encounter high compliance costs in later compliance years. Regulated entities should be required to meet a portion of their compliance obligations on an annual basis to encourage early and proactive emissions reductions and reduce exposure to cost volatility in later compliance years.

II. Structuring Alternative Compliance Options to Drive Investments that Benefit Impacted Communities

Discussion Question 2: *What are your thoughts on whether/how the program could include structuring alternative compliance options to drive investments that reduce greenhouse gases in ways that most benefit Oregon's impacted communities?*

As we noted in sections I.A.3, I.B.3, and I.C.3 of these comments and in our previous comments on alternative compliance mechanisms, ACOs present a valuable opportunity to mitigate some of the equity impacts that could occur under the program and help historically disadvantaged groups and impacted communities transition to zero-emissions technologies. To ensure that ACO programs and projects meet the specific and unique needs of Oregon's diverse impacted communities, local communities should have opportunities and authority to inform and influence decisions regarding the types of projects that are eligible for ACO funding within their communities. Section II.A describes two approaches for administering community-driven ACO programs.

ACOs can help influence *how* regulated entities achieve their emissions reductions—and help ensure that emissions are reduced in an equitable manner that minimizes harms to impacted groups and communities. However, DEQ must also strive to minimize the disparate and inequitable impacts of climate change on impacted communities, so it is imperative that ACOs

are structured to ensure compliance with the cap. In other words, ACOs should not simply act as a flexible accounting mechanism that enables regulated entities to avoid making actual emissions reductions or cancel out emissions increases in other areas. Section II.B briefly describes some of the accounting risks relating to ACOs and offers some suggestions for how the program could be structured to incentivize ACO investments while maintaining the integrity of the emissions cap.

A. Community Input and Oversight

ACO eligibility should be limited to programs and projects that achieve real, measurable, verifiable, additional, and permanent reductions in anthropogenic GHG emissions, and the program should give special preference to ACO programs and projects that meet these criteria while also providing meaningful equity benefits in impacted communities. However, neither DEQ nor the regulated entities making ACO investments possess sufficient knowledge and perspective to adequately determine which kinds of projects will provide the greatest benefits within specific communities. Instead, these determinations should be made at the community level. The people who live and work in impacted communities should have an opportunity to provide input on their communities' specific priorities and needs and determine the types of ACO projects that will provide the greatest benefits within their communities.[9]

In our previous comments on technical workshop 3, we encouraged DEQ to consider allowing Community Emissions Reduction Credit Banks, which are authorized under existing law, to certify, bank, and distribute alternative compliance instruments under the program.[10] This approach would give local county governments oversight authority over ACO programs and projects, and could potentially provide local governments with a mechanism for raising revenues to fund public ACO projects. This approach may be particularly appealing in rural counties with low population densities, where local communities may lack the capacity or resources to administer an ACO program. However, impacted community members must have an opportunity to inform and influence ACO investment decisions.

As an alternative or addition to the Community Emissions Reduction Credit Bank approach, the program could potentially designate a specific non-governmental organization (NGO) to administer an ACO program at the statewide level.[11] Under this approach, the NGO could be responsible for accepting and administering alternative compliance investments from regulated entities, and could be required to collaborate with local communities to identify and develop local ACO projects. This approach would be most effective if the NGO is created for the specific purpose of administering the ACO program, and is governed by a diverse and engaged board of directors.

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[9] In this context, "impacted communities" should include frontline communities that face disproportionate risks from climate change and/or from the transition to a decarbonized economy, as well as historically disadvantaged environmental justice, BIPOC, and low-income communities in urban or rural areas.

[10] Community Emissions Reduction Credit Banks are currently authorized under ORS § 468A.820. *See* Green Energy Institute Comments on Cap and Reduce Technical Workshop 3: Alternative Compliance Options, Sept. 10, 2020, *available at* https://law.lclark.edu/live/files/31438-c-and-r-alternative-compliance-option-gei-comments.

[11] Before selecting this approach, the agency should conduct a thorough legal analysis to determine whether there are any legal restrictions on the types of functions or authority the EQC may delegate to a non-governmental organization.

B. Addressing Double-Counting Risks

Depending on how emissions reductions from alternative compliance investments are accounted for under the program, there are legitimate concerns that ACOs could result in the double-counting of emissions reductions, which could have the effect of raising total emissions above the cap. For example, if a transportation fuel supplier could earn an alternative compliance credit for replacing internal combustion vehicles with EVs, the fuel supplier could increase its available compliance instruments while simultaneously decreasing its compliance obligations.[12] This would enable the fuel supplier to increase its emissions and still meet its compliance obligations, effectively offsetting the emissions reductions from the alternative compliance project. This outcome would undermine the integrity of the cap.

To address this double-counting dillema, DEQ could treat alternative compliance as a form of compliance, rather than a means of creating additional compliance instruments. For example, if a regulated entity reduced emissions through an alternative compliance project, those emissions reductions could be credited to the entity, but the entity would not receive additional compliance instruments to represent those emissions reductions.[13] This approach would avoid the double-counting problem by simply crediting regulated entities with the emissions reductions they achieve, regardless of how they achieve them. However, it could also fail to incentivize regulated entities from investing in alternative compliance projects, particularly if it is less costly to purchase compliance instruments through the market.

There are several potential design options that have the potential to mitigate the double-counting risk while maintaining the incentive to invest in projects that reduce emissions and provide equitable co-benefits in impacted communities. One option would be to withhold a percentage of available compliance instruments in a reserve account, and distribute these instruments to regulated entities that make verified investments in eligible ACO programs or projects. This approach would give DEQ additional control over the level of compliance achieved through alternative investments.

Another option would be to issue alternative compliance instruments that carry additional value over conventional compliance instruments, but require regulated entities to surrender a conventional compliance instrument for every alternative compliance instrument they receive.[14] To create the additional value necessary under this approach, the program would likely need to impose some additional restrictions on the other flexibility mechanisms. For example, the program could restrict the number of compliance instruments a source may hold in the bank, but exempt alternative compliance instruments from this limit. Similarly, the program could limit the

[12] In a very simplistic hypothetical example, imagine the fuel supplier's emissions equaled 100 tons, but the supplier only had 99 compliance instruments. If the fuel supplier's investment in EVs reduced emissions by one ton (thereby creating one alternative compliance instrument), the fuel supplier's emissions would drop to 99 tons, but its available compliance instruments would increase to 100 (99 conventional instruments and one alternative instrument).

[13] Continuing from the hypothetical example from note 12, the fuel supplier's emissions would drop to 99 tons and its compliance instrument balance would remain at 99 instruments.

[14] Rather than view this as a form of "alternative" compliance, it may be helpful to view this model as a form of "compliance-plus" (with the "plus" representing equitable co-benefits).

number of traded compliance instruments a source could use towards its compliance obligations, but exempt alternative compliance instruments from this limit.

A third approach would be to apply a temporal benefit to alternative compliance instruments. For example, if a regulated entity's emissions exceed its compliance instrument supply, the regulated entity could achieve compliance by investing in an eligible alternative compliance program or project. Under this approach, the regulated entity's emissions would exceed its compliance obligations for the compliance period in which the ACO investment was made, and total emissions under the program could potentially exceed the program cap if the ACO investments do not yield comparable emissions reductions during the compliance period. To address this issue, DEQ should adjust the program's compliance instrument allocations in subsequent compliance periods to account for any excess emissions and preserve the integrity of the cap.

III. Multi-Year Compliance Periods

This Part responds to DEQ's discussion questions on multi-year compliance periods. Section III.A discusses alternative compliance period durations, and section III.B discusses the implications of creating an extended initial compliance period.

A. Compliance Period Durations

Discussion Question 3: *Other than a three-year multi-year compliance period, what other compliance period lengths might be considered? Why?*

Shorter compliance periods are generally preferable to longer compliance periods because they would deter regulated entities from taking a wait-and-see approach to compliance. DEQ should explore whether one-year or two-year compliance periods would be feasible if other flexibility mechanisms are available to help regulated entities respond to uncertainties. While some regulated entities may be proactive in reducing emissions in the early years of a MYCP, other entities will likely procrastinate and delay investing in emissions reductions in early years. This strategy could concentrate necessary emissions reductions into later years of the compliance period, which could threaten the integrity of the program if entities are unable to physically reduce multiple years of emissions or purchase a sufficient number compliance instruments to come into compliance in a single year. The program should therefore not extend any compliance periods beyond three years, because the potential non-compliance risks would outweigh the flexibility benefits associated with this strategy.

If the program includes two-year or three-year compliance periods, regulated entities should be required to demonstrate that they are able to meet a portion of their compliance obligations for each year of the compliance period. As we noted in section I, compliance periods must have short enough durations to incentivize early emissions reductions and enable the agency to quickly address and enforce noncompliance by any regulated sources or sectors.

B. Extending the Initial Compliance Period

Discussion Question 4: *What are your thoughts on having a relatively longer compliance period for the program's first compliance period, but shorter ones in the future?*

There are both risks and benefits to setting a longer initial compliance period and shorter subsequent compliance periods. On the one hand, a longer initial compliance period could help regulated entities respond to uncertainties that could emerge in the initial years of the program. On the other hand, a longer initial compliance period could also encourage regulated entities to take a wait-and-see approach that delays investments in early emissions reductions. This risk would be more pronounced if DEQ over-estimates source or sector baseline emissions and/or over-allocates compliance instruments. If low-cost compliance instruments are available for purchase, regulated entities would be more likely to delay making investments in emissions reducing technologies or practices. A longer initial compliance period would therefore only help achieve the program's objectives if DEQ accurately calculates baseline emissions *and* sets an ambitious program cap.

IV. Point of Regulation

Discussion Question 5: *What are your thoughts on benefits of regulating all natural at natural gas utilities? Do you see any additional benefit to regulating natural gas for large stationary sources at the source, instead of the utility?*

While it is imperative that the program regulates GHG emissions from industrial processes at the source level, it likely makes the most sense to regulate direct-use natural gas emissions at the supplier level rather than regulate on-site gas consumption by large industrial sources. There would be some benefits from regulating natural gas emissions at the source level; for example, industrial sources that burn natural gas to produce heat or electricity would have an incentive to install more efficient equipment and maximize on-site energy conservation. However, the risks associated with this point of regulation would likely outweigh the benefits achieved through this approach. Regulating gas use at the source level would subject more sources to direct regulation under the program, which would increase the potential for errors and inaccuracies in the program's baseline emissions calculations and compliance instrument allocations. At best, the total GHG emissions reductions would be equal under both approaches, because all emissions from direct natural gas use would be subject to the same cap. At worst, source-level regulation could result in an over-allocation of compliance instruments that distorts market prices and leads to a glut of banked allowances. A source-level approach would also increase the potential for non-compliance, because there would be many more sources subject to regulation in contrast to a natural gas supplier-level approach.

There are two notable exceptions to this point-of-regulation determination that could shift the scales in favor of a source-level approach. The first exception concerns co-pollutant emissions. When natural gas is used to produce heat or power at an industrial source, reductions in gas consumption may have little to no impact on co-pollutant emissions from industrial processes. In this case, a source-level regulatory approach would not yield meaningful reductions in co-pollutant emissions in comparison to a supplier-level approach. If, however, DEQ identifies

specific industrial sources that could achieve reductions in co-pollutant emissions through reductions in on-site gas use, those sources should be subject to regulation along with other industrial sources that produce process-based GHG emissions. This is particularly important for industrial sources located in or near EJ communities.

The second exception concerns the aggregate emissions reduction potentials of the two approaches. If a supplier-level approach fails to achieve or lacks the potential to achieve sufficient reductions in GHG emissions, DEQ should shift to a source-level approach.

V. Conclusion

We appreciate the opportunity to provide input on the emissions, economic, and equity implications of the different flexibility mechanisms and point-of-regulation considerations raised at the second RAC meeting. Thank you for considering our comments.

Sincerely,
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