



October 18, 2005

EPA Proposes Fundamental Changes to New Source Review Program for Electric Utilities

On October 13, 2005, EPA proposed fundamental changes to the New Source Review (“NSR”) program for electric generating units (“EGUs”) that would make the NSR program more consistent with the New Source Performance Standards (“NSPS”) program. Specifically, EPA proposes to adopt in large part the NSPS definition of “modification,” which is based on increases in the *hourly emissions rate*, and discard the current “actual to projected future actual” test, which is based on *annual emissions increases*. In the process, EPA would also do away with “netting” and “significance thresholds,” which are part of the current regulations. As a result, any increase in the emissions rate would trigger NSR. On the same day, EPA issued guidance indicating it would no longer pursue enforcement for alleged NSR violations that would not violate the provisions of the 2002 NSR Reform rule and this new proposed EGU rule.

Below is a brief summary of this proposal. Part I summarizes the history of the legal issues involved. Part II outlines the major components of EPA’s proposal. Part III identifies legal issues that the proposal raises, including its potential ramifications in light of EPA’s new enforcement guidance.

I. History of the Legal Issues.

Industry and EPA have long argued over the types of changes that should be considered a “modification” under the NSR program. Historically, EPA has taken the position that the NSPS and NSR programs require different interpretations: a project triggers NSPS if it increases the emissions rate, measured on an hourly basis (*e.g.*, lb/hr); a project triggers NSR if it causes a “significant net emissions increase,” measured as tons per year (“tpy”).

From the beginning of the NSR program, industry has challenged various rules that set forth this distinction, because the Clean Air Act itself adopts the NSPS definition of “modification” into the NSR program. *See* CAA §§ 169(2)(C), 171(4). Thus, industry has argued that the NSPS focus on hourly emissions must apply under NSR as well. Due to various delays and settlements, however, these challenges were never decided. As a result, most of the ongoing NSR discussions assumed that NSR applicability was based on increases in annual emissions; the controversy instead focused on the appropriate method of measuring those increases (*i.e.*, using the “actual to potential” test preferred by EPA, or the “actual to actual” test advocated by industry). These discussions came to a head in 2002, when EPA adopted a NSR

October 18, 2005

Page 2

Reform rule that discarded the actual to potential test in favor of an “actual to future actual” test. 67 Fed. Reg. 80,185 (Dec. 31, 2002).

At the same time, however, EPA continued to pursue a major enforcement initiative against the electric utility industry for alleged persistent and systematic NSR violations. In their defense, several utilities reiterated the longstanding industry claim that NSR cannot be triggered absent an increase in the hourly emissions rate. In 2003, one federal court agreed. *See U.S. v. Duke Energy*, 278 F. Supp. 2d 619 (M.D.N.C. 2003). This decision was upheld by the 4th Circuit this past summer. *See U.S. v. Duke Energy*, 411 F.3d 539 (4th Cir. 2005).

The *Duke Energy* decisions did not settle the issue, however. Less than two weeks after that decision, the D.C. Circuit Court of Appeals rejected this concept in industry’s challenge to EPA’s 2002 NSR Reform rule, but attempted to sidestep the apparent conflict with the *Duke Energy* decision by claiming that the industry petitioners had not raised precisely the same arguments as in the 4th Circuit case. *See State of New York v. U.S. Environmental Protection Agency*, 413 F.3d 3 (D.C. Cir. 2005).

II. Summary of EPA’s Current Proposal

On October 13, 2005, EPA proposed to resolve this dispute, at least as it applies to EGUs. Highlights of the rule include:

- The rule only applies to EGUs; other types of sources would remain regulated under the current NSR regulations (*i.e.*, the “actual to future projected actual” test). An EGU includes any fossil-fuel fired boiler or turbine serving an electric generator with a nameplate capacity greater than 25 MW producing electricity for sale. This definition is somewhat broader than the definitions used under the current NSPS and NSR rules, and includes cogeneration facilities and simple cycle gas turbines that do not currently qualify as “electric utility steam generating units” under the existing regulations.
- For EGUs, EPA would define a “modification” as one that increases the facility’s “maximum *achievable* hourly emission rate.” Increases would be determined as they are under the current NSPS program, that is, through stack tests, material balances, or other similar mechanisms.
- EPA also seeks comment on two alternative definitions: one based on a facility’s “maximum *achieved* hourly emission rate;” and one based on mass of emissions per unit of energy output (*e.g.*, lb/MW hr, nanograms/Joule). The former definition would be based on historical data, such as that obtained from CEMS, and would not allow the facility to demonstrate that past operations did not reflect its true achievable capacity. The latter definition would, in EPA’s view, encourage energy efficiency projects and the installation of newer, more efficient units.

October 18, 2005

Page 3

- Under any of the three interpretations, the “significance” levels in the current NSR program would not apply to EGUs. Thus, *any* increase in the hourly emissions rate (however measured) would trigger NSR. EPA has requested comment on this issue.
- Similarly, EPA proposes to do away with contemporaneous netting under the new rule. Thus, any project that increases the hourly emissions rate would trigger NSR, regardless of whether the facility could otherwise use emissions reductions to net out of review. Alternatively, EPA is considering shortening the “contemporaneous” period to allow only “project” netting, so that different facets of the same project could be used to net out of review, but emission reduction credits from past projects could not.
- None of the new provisions would apply to new EGUs. New units would continue to be subject to the current NSR regulations.
- The proposed rule would be a mandatory element of a State SIP. A State that decides not to implement the changes would be required to demonstrate that its program is no less stringent than the federal program.

At the same time the EGU proposal was released, EPA also issued new guidance on its enforcement priorities. *See* Memorandum from M. Peacock, Deputy Administrator, EPA, to Regional Administrators and State Environmental Commissioners (Oct. 13, 2005) (“EGU Enforcement Guidance” or “Guidance”). The Guidance focuses on emissions reductions that have been and will be obtained from the power sector as a result of the Clean Air Interstate Rule and the Clean Air Visibility Rule, and explains that EPA intends to “update” its enforcement strategy in light of these reductions. While the Guidance indicates that EPA should still continue to pursue ongoing enforcement actions, it asks OECA to “refocus its resources on other areas that will likely produce significant environmental benefits.” *Id.* at 2. Accordingly, the EGU Guidance indicates that EPA will focus any future enforcement efforts only on actions “that would violate our NSR reform rules and our latest NSR utility proposal.” *Id.*

III. Significant Issues Raised by the Proposal and Guidance

The proposal and EGU Enforcement Guidance raise a number of important legal issues that merit review and comment by industry. These include:

- EPA’s decision to limit the rule to EGUs is questionable, at best. The *Duke Energy* decision was based on the plain language of the statute and Congressional intent, *not* the type of emissions units in question. The proposal appears to be laying the groundwork for justifying this distinction based on the number of utility-specific rules that have been promulgated since the NSR program came into being (Acid Rain, CAIR, Regional Haze, NO_x SIP Call, etc.). As EPA views the issue, these more recent programs authorize it to exercise its administrative discretion to re-define “modification” for those types of units regulated under these programs. Whether these programs justify a different regulatory

October 18, 2005

Page 4

regime for utilities, however, would appear to be a decision for Congress, not EPA. We see no basis for limiting the rule to EGUs, and we recommend that other industries file comments with EPA making this point.

- EPA's decision to disallow consideration of the "significance" levels and contemporaneous netting authorized under the current NSR rules is also questionable. This interpretation may be authorized under the 4th Circuit decision in *Duke Energy*, which implies that the definition of modification under NSR and NSPS must be precisely the same. It is inconsistent, however, with the *Duke Energy* District Court's prior decision, which held that a project must cause both an increase in the hourly emissions rate and a "significant net emissions increase" on an annual basis.
- EPA justifies the proposed rule largely on the grounds of simplicity and administrative convenience. The Agency claims that making NSR applicability consistent with the existing NSPS program will ease confusion, lessen the administrative burden on both EPA and regulated sources, and encourage efficiency projects. However, by limiting the new rule only to EGUs (and to existing EGUs at that), the Agency makes the proposal needlessly complicated. If a facility contains both an EGU and other types of sources, the owner will be able to use the new rule for any modifications to the EGU, but will nevertheless still remain subject to the old rules for the other sources at the facility. Similarly, if a source contains more than one EGU, it is likely that the owner will, over time, both modify the existing units (which will be regulated under the new rule) and install new units (which will be regulated under the old rules). In both circumstances, determining and documenting applicability will be more complex, not less, because the owner must use separate tests for the different pieces of equipment. Thus, rather than doing away with the complex contemporaneous netting approach of the old rules, the proposal will simply add another layer of review and documentation for the different types of equipment involved. Finally, it is difficult to see how the proposal will encourage the replacement of older, more-polluting units with newer, more efficient ones, when the installation of any new units is specifically excluded from the new rule. If EPA truly wanted to simplify the NSR rules, it would apply the proposed rule to all sources, old or new, EGU or non-EGU. Again, we recommend that companies file comments with EPA making this point.
- While EPA effectively adopts the *Duke Energy* decision, it continues to state its disagreement with that Court's holding. Rather, the Agency bases its proposal entirely on *Chevron* deference in the face of what EPA continues to characterize as an ambiguous statute.