



Auctions, Direct Sales, and Independent Power Producers Written Guarantee Regulations

In May 1991, the U.S. Environmental Protection Agency proposed the Auctions, Direct Sales, and Independent Power Producers (IPP) Written Guarantee Regulations (Subpart E, 40 CFR Part 73). In December 1991, these regulations were promulgated, becoming the first Acid Rain Program regulations to be implemented under Title IV of the Clean Air Act Amendments of 1990. This fact sheet discusses the key components of these regulations and the role that auctions, sales, and IPP written guarantees will play in the market-based allowance trading system.

Introduction

EPA's Acid Rain Program will establish an innovative, market-based allowance trading system to achieve a 10-million-ton reduction in sulfur dioxide (SO₂) emissions, one of the primary precursors of acid rain. Under this system, fossil-fuel-fired power plants, the principal emitters of SO₂, will be allotted tradeable "allowances" based on their past fuel usage. Each allowance entitles a unit to emit 1 ton of SO₂ during or after the year specified on the allowance. At the end of the year, the number of allowances a unit holds must equal or exceed total emissions at that unit; otherwise, stringent penalties will apply.

Allowances may be bought, sold, or banked like any other commodity. If a utility holds surplus allowances, it may sell them to units whose emissions levels exceed their allowance supply, or it may save them for use in future years. EPA envisions the emergence of an active allowance market in the coming years, where brokers, environmental groups, and utilities alike will participate in allowance transactions.

Because the availability of allowances is crucial to ensure both the economic efficiency of the emissions limitation program and the addition of new electric-generating capacity, Title IV of the Clean Air Act Amendments mandates that EPA hold

or sponsor yearly auctions and direct sales of allowances for a small portion of the total allowances allocated each year. In addition, Title IV requires that EPA provide a written guarantee ensuring priority for certain new independent power producers (IPPs) in purchasing allowances in the direct sales. The auctions, sales, and IPP guarantee provisions of Title IV should provide some certainty that units, including new IPPs, will have a public source of allowances beyond those allocated initially to existing units. Moreover, the auctions are expected to help signal price information to the allowance market early in the regulatory program.

Where Will the Allowances Come From?

To supply the sales and auctions with allowances, EPA will set aside in a Special Allowance Reserve 2.8 percent of the total annual allowances allocated to all units. During Phase I, when the allowance pool will total 5.7 million allowances annually, 150,000 allowances will be available every year for auctions and another 25,000 allowances reserved for the direct sales. During Phase II, when allowance pool totals will increase to 8.9 million allowances yearly, 200,000 allowances will be earmarked annually for auctions and 50,000 designated for the direct sales.

Private allowance holders (such as utilities or brokerages) also may offer their allowances for sale at the EPA auctions, provided that the allowances are dated either for the year in which they are offered, for any previous year, or for 7 years in the future. Authorized account representatives must notify EPA of their intent to sell at least 15 business days prior to an auction. The account representatives must specify the number of allowances they are offering and their minimum price requirements.

How Will EPA Conduct Auctions?

Auctions and direct sales commence in 1993 and will be held each year thereafter. EPA will organize an allowance auction no later than March 31 of every year. Auctions will be divided into two segments: (1) a "spot" allowance auction, in which allowances will be sold that can be used in that same year for compliance purposes, and (2) an "advance" auction for the sale of allowances that will become valid 7 years after the transaction date, although they can be traded earlier. Bidders must send sealed offers containing information on the number and type ("spot" or "advance") of allowances desired and the purchase price to EPA no later than 3 business days prior to the auction. Each bid

must also include a certified check or letter of credit for the total bid cost.

EPA will sell allowances from the Special Allowance Reserve on the basis of bid price, starting with the highest-priced bid and continuing until all allowances have been sold or the number of bids is exhausted. EPA may not set a minimum price for allowances from the Special Allowance Reserve.

The Agency will sell allowances from the Special Allowance Reserve before it begins auctioning off allowances offered by private holders. EPA will sell "offered" allowances in ascending order, starting with the allowances for which private holders have set the lowest minimum price requirements. The Agency will sell offered allowances until the allowance supply is depleted, bids are used up, or the minimum price for the next set of offered allowances exceeds the maximum purchase price of the next bid.

EPA will return proceeds and unsold allowances from the auctioning of reserve allowances on a *pro rata* basis to those units from which the Agency originally withheld allowances to create the Special Allowance Reserve. Proceeds from the sale of offered allowances will be returned to private allowance holders that contributed the allowances to the auction. EPA will likewise return payment from unsuccessful bids and allowances from unsuccessful offers.

How Will Direct Sales Be Conducted?

EPA will begin the direct sale of allowances on June 1 of each year and continue transactions until all allowances are sold or 10 days before the allowance transfer deadline, whichever comes first. During Phase I, the EPA direct sales will offer only "advance" allowances (see above). From the year 2000 onward, organizations and individuals will also be able to purchase "spot" allowances at the direct sales. EPA will offer allowances for \$1,500 each, indexed to inflation.

Any individual or organization may purchase allowances at EPA-sponsored direct sales by submitting the proper application materials, which specify the number and type ("spot" or "advanced") of allowances desired. EPA will consider and grant conditional approval on applications

based on order of receipt. Upon approval, allowances are reserved under the name of the applicant. Approved applicants must tender 50 percent of the total payment within 6 months of the date on which their request was affirmed by EPA; the second half must be paid on or before the allowance transfer deadline. Payment defaults will result in a withdrawal of purchase requests by EPA. The Agency will transfer allowances only after full payment is received. In the case that requests exceed available allowances, applicants will be placed in a waiting line on a first-come, first-served basis. If, by the allowance transfer deadline, the direct sales reserve has not been exhausted, the allowances not sold in the direct sales will be offered at the next year's auctions. Unsold "advance" allowances will be sold at an additional "advance" auction; unsold "spot" allowances will be offered in the regular "spot" auction.

Similar to the auction program, EPA will portion proceeds from the direct sale of allowances on a *pro rata* basis to those units from which EPA withheld allowances to create the direct sales reserve.

What Are IPP Written Guarantees?

To maintain the total emissions cap of 8.9 million tons of SO₂, Title IV requires new units (most units commencing operation after passage of the Act) to obtain allowances from existing allowance holders or through the auctions and sales programs. New IPPs that can certify that their efforts to acquire allowances from affiliate utilities and all Phase I units have been unsuccessful may be eligible to apply for an IPP written guarantee. The guarantee establishes an IPP's prerogative to purchase allowances from the Special Allowance Reserve for \$1,500 before these allowances are made available to other parties. Written guarantees are intended to secure financing to new IPPs by assuring lenders that new independent power projects have access to the allowances needed.

Applicants may request a guarantee for the useful life of the unit, up to 30 years, beginning in the year 2000. In the application, IPPs must specify their emissions limitations and the number of allowances requested. Once EPA approves the ap-

plication, the IPP will be eligible to purchase allowances (up to the number stated on the application) from the direct sale in any year for the duration of the guarantee, provided the IPP alerts EPA of its intent to exercise the guarantee by April 15 in each year that direct sales are held. If direct sales are discontinued, EPA will still honor the written guarantees and provide new IPPs with allowances. To continue to hold a guarantee, holders will need to certify a continuing need for the guarantee. In addition, EPA can terminate the guarantee if the IPP does not fulfill certain requirements.

Easing Compliance, Ensuring Growth

EPA's auctions and sales program will help ease compliance with the emissions limitations established under Title IV of the Clean Air Act Amendments. Agency-sponsored auctions and direct sales will furnish utilities and other groups with additional options for purchasing allowances, thereby enlarging and stimulating the allowance trading market. In addition, giving new IPPs priority in acquiring allowances should help to ensure continued growth in the nation's energy generation capacity.

For More Information

For more information, write to:

U.S. EPA Office of Air and
Radiation
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If you would like to receive other fact sheets in this series, call the Acid Rain Hotline at (617) 641-5377 or the EPA Public Information Center (PIC) at 202-260-2080.

Fact sheets are available on the following subjects:

- Allowance System
- Continuous Emission Monitoring
- Environmental Benefits
- Excess Emissions
- Permits
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