#### State of Oregon

Department of Environmental Quality Memorandum

**Date:** November 2, 2012

**To:** Environmental Quality Commission

**From:** Dick Pedersen, Director

**Subject:** Agenda item xx, Rulemaking: Oregon Clean Fuels Program

December 6-7, 2012, EQC meeting

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| **Why this is important** | The Oregon Clean Fuels Program is a component for several important Oregon initiatives to reduce greenhouse gas emissions including Oregon's energy, transportation and climate protection action plans. Approximately one-third of Oregon’s greenhouse gases come from transportation sources, and providing cleaner fuels will help reduce these emissions. This rulemaking provides the initial framework of the program that is foundational to an eventual low carbon fuel standard. |
| **DEQ recommendation and EQC motion** | DEQ recommends that the Oregon Environmental Quality Commission adopt the proposed rules for the Oregon Clean Fuels Program, as provided in attachment A of this staff report. |
| **Background and need for rulemaking** | The 2009 Oregon Legislature authorized the Environmental Quality Commission to adopt a low carbon fuel standard, with the goal to reduce greenhouse gas emissions from Oregon’s transportation fuels. DEQ worked with stakeholders to develop the framework to implement the standard. In April 2012, Governor Kitzhaber asked DEQ to begin the rulemaking process to adopt the Oregon Clean Fuels Program. |
| **Effect of rule** | If adopted, the rules would create the first phase of the Oregon Clean Fuels Program.The rules would require Oregon fuel producers and importers to register, keep records and report to DEQ the volumes and carbon intensities of the fuels they provide in Oregon. This would allow DEQ to gather valuable data about Oregon’s transportation fuels that will help inform DEQ and decision makers about the feasibility of moving ahead with the next phase of the program. This is also intended to provide DEQ and regulated parties time to fully develop recordkeeping and reporting protocols and systems.The next phase would require regulated parties to reduce the average carbon intensity of fuels they provide in Oregon each year, with the ultimate goal of reducing greenhouse gas emissions by 10 percent from the 2010 levels. For the next phase to be developed, the Oregon Legislature will need to remove the statutory December 31, 2015 sunset that is currently in effect and the Oregon Environmental Quality Commission will need to adopt additional rules. |
| **Commission authority** | The commission has authority to take this action under Oregon Laws 2009, chapter 754, also referred to as House Bill 2186 (2009). |
| **Key issues** | DEQ’s initial proposal was for the EQC to adopt rules describing a two phased program, with Phase 1 registration, recordkeeping and reporting to be implemented now and Phase 2 compliance with the standards) to be implemented at a later date. As initially proposed, implementation of the Phase 2 rules (standards) was indefinitely deferred pending further approval by the Oregon Legislature and the EQC. During the comment period, several stakeholders cited their concern that implementing the Clean Fuels Program would put Oregon businesses at a competitive disadvantage compared to businesses operating in other states without a similar program. Specifically, they cited unresolved legal issues in California, resources to implement the program, the potential economic impact of the program, and the legislative sunset date as reasons not to move forward with the program. To allow time for resolution of these issues while providing a clear regulatory framework for the entire program, DEQ initially proposed to adopt the program in its entirety but indefinitely defer Phase 2. However, many stakeholders were uncomfortable with this deferral approach and suggested waiting to adopt Phase 2 of the rules until after further discussions with the Legislature.In light of the comments received, DEQ has proposed to modify its initial rule language to remove the references to the second phase of the program, including language describing: * compliance with the declining annual average carbon intensity standards;
* the generation, banking and transfer of credits and deficits; and
* the deferral mechanisms for fuel shortages and fuel cost increases.

The revised proposal now focuses exclusively on implementing the initial registration, recordkeeping and reporting requirements, which accomplishes the same outcome as the initial proposal. While Phase 2 will not be adopted at this time, the model rule language for Phase 2 will remain available for review.The revised proposal allows DEQ to begin work with regulated and opt-in parties to build the reporting framework necessary to the success of the next phase of the program, while allowing time for additional discussion about the Phase 2 program design with stakeholders and the Oregon Legislature. This approach also reinforces the regulatory flexibility focus of the authorizing statute. In order to implement the registration, recordkeeping and reporting requirements of the first phase, the proposed rules also include several other core administration features including:* the designations of the regulated parties for the various fuels,
* the transfer and receipt of the compliance obligation,
* the process to propose and gain approval for a carbon intensity value, and
* the methodology to determine the amount of surpluses and shortfalls (previously credits and deficits) and calculate net carbon balances.

DEQ will utilize these reports and other information to make a recommendation to the Oregon legislature and EQC about the next phase of the program. DEQ remains committed to working with stakeholders and elected officials to continue developing the Clean Fuels Program.* Legal status of California’s program – DEQ received comments that stakeholders are concerned that DEQ’s proposal is unconstitutional based on legal proceedings occurring in California. Oregon’s program is modeled after California's Low Carbon Fuel Standard, but contains several customizations for Oregon, many of them required by statute. In December 2011, a federal district court ruled that the California LCFS impermissibly regulates interstate commerce. California appealed this ruling to the United States Circuit Court of Appeals for the Ninth Circuit, and the Ninth Circuit stayed the district court’s ruling. This allows California to implement its LCFS while the Ninth Circuit considers whether to uphold or reverse the district court’s ruling. A final ruling is expected in 2013.

DEQ is watching these developments closely and continues to analyze how it might affect Oregon’s program. Because the first phase of its program does not raise the legal issues at issue in the California lawsuit, Oregon may move forward with this phase prior to conclusion of the lawsuit. This allows Oregon to achieve the benefits of the program as soon as possible and to incorporate any program revisions required by the court in the design of the next phase.* Fee authority and the ability of DEQ to adequately implement the program – DEQ received comments that stakeholders are concerned that DEQ lacks adequate resources to implement the program. At this time, there is no funding source to implement the Clean Fuels Program. DEQ has a small group of air quality planning staff that is funded to develop new air quality programs, including programs to meet federal air quality standards, reduce risk from air toxics, reduce greenhouse gases and meet federal visibility protection requirements. DEQ was able to develop of the Clean Fuels Program by temporarily assigning existing planning staff to this work and delaying other work. The planning staff must now turn to other challenges, such as addressing new National Ambient Air Quality Standards and reducing risk from air toxics exposures, and is not available to implement the Clean Fuels Program.

DEQ is proposing to introduce a legislative concept and policy option package (for up to $475,000 for the 2013 – 2015 biennium) to request authority to charge a fee to regulated parties. If approved by the Legislature, the fee will be used to hire 1.3 fte of additional staff to implement the first phase of the program and assess the feasibility of moving to the next phase, including funds to hire outside expertise to assist the agency.* Scope of the fiscal and economic analysis - DEQ received comments that stakeholders are concerned that the scope of the fiscal and economic analysis conducted for this rulemaking was incorrect. As initially published for public comment, DEQ’s proposal was divided into Phase 1 and Phase 2 of the program, with Phase 2 requirements deferred pending future EQC and legislative action.

DEQ convened a fiscal advisory committee to provide input on the Statement of Need and Fiscal and Economic Impact developed for this proposed rule. In it, costs for regulated parties to comply with Phase 1were estimated for both initial start-up and ongoing maintenance. Since Phase 2 was deferred, no requirements were imposed; therefore, its fiscal and economic impact was zero. Since the revised proposal is to include only the first phase of the program, the assumptions made in the initial Statement of Need and Fiscal and Economic Impact remain the same. If DEQ proposes rules for the next phase of the program, a Statement of Need and Fiscal and Economic Impact will be prepared at that time. * Sunset date in HB 2186 - DEQ received comments that stakeholders feel that DEQ should not proceed with the program until the legislative sunset date is removed. HB 2186 contains a sunset date of December 31, 2015 and, unless the sunset is removed, the Clean Fuels Program cannot be implemented beyond that date. It would not be practical to establish and require compliance with the declining average carbon intensity standards and potentially have it end in 2015. Therefore, DEQ proposes to move forward with only the first phase of the program until after the sunset is removed by the Legislature. If the sunset is lifted, an additional rulemaking by the EQC will be needed to adopt and implement the standards.
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| **Public outreach** | DEQ developed the rules based on discussions and recommendations from a 29-member advisory committee that helped DEQ explore technical issues and policy choices for designing the Oregon Clean Fuels Program. The committee included representatives of many areas of expertise, including petroleum fuel, low carbon fuel, environment, labor, farm, construction, trucking and rail. DEQ also convened an advisory committee to gather input on the fiscal impact of complying with the requirements of the proposed rules. Eleven people from the business and environmental communities were invited to participate on the committee and, along with members of the public, were provided an opportunity to comment on the draft Statement of Need and Fiscal Impact.Comments on the proposed rules were accepted from the public from July 20, 2012 through Aug. 31, 2012. A public hearing was hosted by the Oregon Environmental Quality Commission on Aug. 24, 2012. The hearing was held at 811 SW 6th Avenue in Portland. For that hearing, members of the public could also visit a DEQ regional office in Eugene, Medford, Bend or Pendleton for the opportunity to provide oral testimony via conference phone. 102 comments were received from the public, including 16 individuals who provided oral testimony at the public hearing. Oral and written comments are summarized in the attached Summary of Public Comment and Agency Response.  |
| **Next steps** | If the rules are adopted, DEQ will file the rule record with the Oregon Secretary of State. Oregon fuel producers and importers will be required to register with DEQ beginning on January 1, 2013 but no later than June 30, 2013. They must submit documents showing, among other things, the volumes and carbon intensities of the fuels they plan to provide in Oregon after July 1, 2013. Beginning on July 1, 2013, Oregon fuel producers and importers are required to begin keeping records for each fuel transaction. The first annual report, for the period of July 1, 2013 – December 31, 2013, will be due on April 30, 2014. The first quarterly report, for the period of January 1, 2014 – March 31, 2014, will be due on May 31, 2014.DEQ intends to develop an electronic registration form and a web-based reporting tool for regulated parties to use in the first phase of the program. Since many of the regulated parties in Oregon also supply fuel in California, DEQ chose to collaborate with California to adapt and customize their registration and reporting tools for use in Oregon in order to streamline the recordkeeping and reporting processes.DEQ intends to propose a legislative concept to the 2013 Oregon Legislature to request that the sunset be removed from HB 2186. DEQ also intends to propose a legislative concept to the 2013 Oregon Legislature to request fee authority and a policy package to spend up to $475,000 for the 2013-2015 biennium.  |
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| **Attachments** | Proposed rules (redline)Proposed rules (clean)Summary of Public Comment and Agency ResponsePresiding Officer’s ReportRelationship to Federal RequirementsStatement of Need and Fiscal and Economic ImpactLand Use Evaluation Statement |
| **Available upon request** | HB 2186Oregon Low Carbon Fuel Standards Advisory Committee Process and Program DesignEconomic Impact Analysis of the Low-Carbon Fuel Standard Rule for the State of Oregon |
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 Approved:

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