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NEW SOURCE REVIEW: UPDATE ON EQUIPMENT REPLACEMENT PROVISION

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EPA recently petitioned the D.C. Circuit to rehear its March decision vacating EPA's 2003 "equipment replacement provision" (ERP) rule. The ERP would have substantially expanded and clarified the existing exclusion for "routine maintenance repair and replacement" (RMRR) for projects at major sources of air emissions that otherwise would trigger new source review (NSR) requirements under the Clean Air Act. In explaining the "exceptional importance" of this case, EPA's petition for rehearing is forthright that the ERP was part of a broader policy shift to rely on cap-and-trade programs to address air pollution more cost effectively than through what is a more haphazard and litigation-plagued NSR program. The D.C. Circuit's decision not only invalidated the ERP but also gave the RMRR exclusion an exceedingly narrow construction. On June 30, the D.C. Circuit denied EPA's petition for rehearing. Pending a potential EPA request for Supreme Court review, the ERP decision is a clear setback to EPA's clean air strategy. For industry, the decision increases the risks of renewed litigation challenging historic projects and heightens the importance of carefully vetting current and future projects to manage NSR risks.

Background

What is "New Source" Regulation?

EPA's new source programs under the Clean Air Act require new major sources of air emissions and modifications that increase air emissions to undergo complex permitting and installation of stringent emissions control technology that can cost many millions of dollars. These programs include New Source Performance Standards (NSPS), which establish basic control requirements for different industrial categories; Prevention of Significant Deterioration (PSD) that requires extensive permitting

and a best available control technology review for sources in areas meeting air quality standards; and Nonattainment New Source Review (NNSR) that requires similar extensive permitting and the most stringent emission control technology review for sources locating in areas not meeting the ambient air quality standards. (PSD and NNSR are commonly referenced collectively as NSR.) The thinking underlying all of these programs is that it is less expensive to install controls on new sources at the time they are constructed or existing sources at the time they undergo significant modifications, and turnover of the industrial fleet would eventually lead to better emissions control, just as new cars with lower emissions standards replace old cars.

The "Modification" Rule

It has been fairly straightforward to determine when a source is "new" and thus should be built with current emissions control technology. The scope of what is a "modification" triggering NSR requirements, however, has been the subject of extensive dispute and litigation. Congress defined "modification" for NSPS in 1970 as "any physical change in, or change in the method of operation of, a stationary source which increases the amount of any air pollutant emitted by such source or which results in the emission of any air pollutant not previously emitted." When Congress codified the PSD and NNSR programs in 1977, it cross-referenced this NSPS definition. For PSD and NNSR, a physical or operational change is excluded if it does not increase emissions by more than a specified *de minimis* threshold in tons per year, pursuant to a complex set of rules. For NSPS, any increase in the hourly emissions rate qualifies. The difficulty with the definition has been EPA's interpretation and line-drawing that inherently must separate projects triggering expensive and time-consuming permitting and retrofit of controls versus projects to which no such requirements apply at all. Of course, pressure can be tremendous for sources to avoid crossing that line.

EPA's Exclusion for Routine Maintenance

A particular subject of dispute has been EPA's effort, since the inception of these programs, to apply a practical exclusion from the definition of "modification" (and thus from triggering new source requirements), for "routine maintenance, repair, and replacement," or RMRR. EPA's practice has been to determine whether a project constitutes RMRR on a case-by-case basis "weighing the nature, extent, purpose, frequency, and the cost of the work as well as other factors to arrive at a common sense finding." 67 Fed. Reg. 80,290, 80,292 (Dec. 31, 2002). It is not surprising that such an inexact test has led to litigation, especially when so much rides on the outcome of the "common sense finding." For example, in cases initiated in the Clinton administration EPA alleged that the coal-fired electric utility industry undertook substantial projects in the past to replace failing equipment that had been causing outages at the plants, and the replacements thereby caused annual emissions increases above the *de minimis* threshold levels. EPA has argued that the projects did not qualify as RMRR, which EPA contends is an exclusion to be construed very narrowly. In those cases, industry and EPA have argued about whether what is "routine" should be considered based on the frequency of the project in the particular industry (like perhaps a transmission overhaul once in the life of a car), or at the particular emissions unit in question (like an oil change on a car). The courts have come out both ways.

Current EPA Policy and the Equipment Replacement Provision

The current administration takes the broad policy view that the goal of achieving needed emissions reductions is not well-served by reliance on the vagaries of sources triggering new source requirements by crossing the boundary around what is RMRR. The administration contends that restricting what plants can do as RMRR without triggering burdensome new source requirements simply deters plants from projects to modernize and increase production efficiency. Instead, the administration considers it preferable to identify an overall emissions reduction goal or "cap," issue an amount of emissions allowances that add up to the cap and then look to industry to determine how most efficiently to install controls to reach the cap by trading the emissions allowances among themselves. EPA has adopted the Clean Air Interstate Rule and the Clean Air Mercury Rule based on this "cap-and-trade"

philosophy, and the administration has sponsored Clear Skies legislation on this same model.

Consistent with this preference for "cap-and-trade," EPA amended the RMRR exclusion in October 2003 by adopting the "ERP," which establishes an expanded and bright line exclusion. Specifically, under the ERP, replacement of equipment with identical or functionally equivalent equipment is excluded from NSR and need not undergo case-by-case RMRR consideration, as long as the project involves a "functionally equivalent" replacement and does not: (1) cause the source to exceed any applicable emissions limits; (2) change a process unit's basic design parameters; or (3) exceed 20 percent of the capital cost of constructing a process unit. EPA's fundamental legal argument was that such equipment replacements do not qualify as a "physical change" to the source. 68 Fed. Reg. 61,248, 61,280 (Oct. 27, 2003).

The ERP Litigation

New York v. EPA, *2006 WL 662746*

Various states and environmental groups challenged the ERP rule in the D.C. Circuit, arguing that its expansion of the exclusion from the modification rule from a purportedly narrow exception for routine maintenance is contrary to the statutory definition of "modification." The petitioners argued that the "ERP is contrary to the plain text . . . because the statutory definition of 'modification' applies unambiguously to any physical change that increases emissions, necessarily including the emission-increasing equipment replacements excused from NSR by the rule."

In a March 17 decision, the D.C. Circuit agreed and vacated the ERP as contrary to the plain language of the statutory definition of "modification." The court of appeals began by observing that EPA has for more than two decades applied the prior RMRR exclusion as limited to *de minimis* circumstances. The court read the term "*physical change*" in its common-sense usage to include equipment replacements, and the words "*any* physical change" to be expansive. The court found it consistent with the statutory context for Congress to have intended the definition of "modification" to reach "any type of physical change that increases emissions." Specifically, the court explained that the expansive meaning of "any physical change" is limited by the strict requirement that the change increase emissions. The court acknowledged that *de minimis* increases in emissions may be excused based on the agency's inherent authority to overlook "trifling" matters involving "miniscule" emissions increases, but not on any other basis. Accordingly, the court concluded that the ERP is invalid because (1) the definition of "modification" does not (as the ERP would) include any limitation to projects that are costly or major; and (2) the ERP would excuse equipment replacements that result in non-*de minimis* emissions increases.

Petition for Rehearing En Banc

EPA petitioned for rehearing on May 1, 2006. The petition reflects the great significance EPA is giving this decision and might foreshadow an intent to seek Supreme Court review.

In the petition, EPA is perhaps more transparent than ever before that its ERP rule is part of a fundamental policy shift toward cap-and-trade to enhance the cost-effectiveness of air quality improvements. The agency urges that the panel's decision will frustrate its efforts to remove NSR disincentives for plant investments in efficiency, and could force installation of controls even at sources that might more cost-effectively have achieved reductions by purchasing allowances in the cap-and-trade programs.

Substantively, EPA points out that its historical RMRR test was not, as the court concluded, based on an exception for *de minimis* emissions increases. Specifically, the RMRR factors (nature, extent, frequency, cost) do not address whether the project in question would increase emissions at all. Indeed, EPA points out that EPA's NSR regulations separately exempt from the definition of modification projects that are not routine if they result in a *de minimis* emissions increase below a specific threshold in tons per year. Accordingly, if the emissions increase were *de minimis*, it would not be subject to NSR regardless of whether it were routine. In that case, the RMRR

exclusion would be superfluous. The only criterion that would matter is whether there is an emissions increase.

Rather, EPA emphasized that its exceptions from the definition of "modification" were not justified as excepting *de minimis* emissions increases but rather aimed to provide industry with "economically necessary operational flexibility." EPA urged that Congress ratified the propriety of this approach in the 1977 Amendments when those RMRR exception was already in place in the NSPS regulations and Congress cross-referenced the definition for NSR. That approach, EPA urged, is essential to support rather than undermine its new cap-and-trade programs, with what the agency calls "significant implications for the efficiency of the United States economy."
As noted above, the D.C. Circuit recently denied EPA's petition for rehearing.

Implications

Pending a potential petition for Supreme Court review, the D.C. Circuit's ERP decision deals a significant setback to the effort to move beyond NSR and related litigation to what EPA regards as more constructive efforts to set and achieve overall goals through cap-and-trade programs. For industry, the decision obviously removes bright-line safe-harbor ERP criteria for concluding that projects are not subject to NSR. In addition, the decision has a potentially far-reaching effect on the pre-existing debate over the scope of the RMRR exemption. Taken on its face, district courts considering how broadly to construe "routine maintenance" will have to contend with the D.C. Circuit's reasoning that the only acceptable exclusion from the definition of "modification," including RMRR, is for projects that have a *de minimis* impact on emissions. As EPA urged in its petition for rehearing, that renders the exclusion so narrow as to be seemingly superfluous.

The ruling may stimulate further the interest of states and environmental organizations to pursue actions alleging that industry's past activities in replacing equipment did not qualify as RMRR, increased emissions, and violated the statute by failing to undergo NSR.

For current and future projects, the conservative course is to focus on emissions impacts, and to manage equipment replacements to avoid an emissions increase. That requires careful attention to the complex rules for evaluating the emissions increase anticipated to result from a project. It also requires that the company's knowledgeable regulatory and legal experts work closely with those managing maintenance, repair and replacement activities so that the projects can be vetted and planned to minimize risk.

AMERICAN BAR ASSOCIATION
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14th Section Fall Meeting
Oct. 4-7, 2006
San Diego, California

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An Introduction to the Practice of Environmental Law
Oct. 5-6, 2006
San Diego, California

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Oct.7, 2006
San Diego, California

36th Annual Conference on Environmental Law
March 8-11, 2007
Keystone, Colorado

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