# PENNSYLVANIA MUNICIPAL AUTHORITIES ASSOCIATION

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## Testimony for House Agriculture and Rural Affairs Committee
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The Pennsylvania Municipal Authorities Association (PMAA) recognizes that trading may be a valuable tool to help Pennsylvania meet its goals under the 2000 Chesapeake Bay Agreement. However, concerns with the current trading program have prevented its use as a ready option to meet nutrient reductions, especially for sewage treatment plants.

Situations differ from treatment plant to treatment plant and also in the communities they serve. Residential growth, economic development, upgrades required for other environmental regulations, aging infrastructure upgrades, engineering and design issues, financial wherewithal, and demographics of customer base are all factors to consider when a community debates the best way to achieve their nutrient reduction limits.

PMAA developed an issues paper addressing concerns our members have with the current version of DEP's Trading Program. Below is a summary of those concerns:

1. Not a feasible option for large plants experiencing growth, constructing other needed or mandated upgrades, or wishing to control their own ability to meet requirements.
2. State bidding law governing purchases for local government entities prohibits any purchases over $10,000 without advertising and bidding procedures to protect expenditure of public monies. This applies to purchase of credits.
3. Credit availability is uncertain now and in the future. If a community opts to trade rather than build they would need 20-25 years worth of credits available, at a cost less than construction of a facility.
4. Cost of credits is currently estimated between $5-$9/ lb, while construction costs amortized over term of bond issue may be as low as $2-$7/ lb.
5. Credit production by agriculture requires practices that exceed baseline on an annual basis. This is subject to weather factors (flood, drought, snow cover), cost of supplies, crop commodity prices, regulatory oversight and contract conditions. Treatment plants may also have a responsibility to ensure these credits are produced if they are buying under contracts. There is little interest by treatment plants to "enforce" this production, particularly if they can control their own plant operation to meet limits.
6. The trading program is not a simple publicly managed "bank" where farmers deposit credits and treatment plants or developers pay to withdraw them. Instead, a privately managed system exists requiring all entities to enter into contractual agreements outside of state bidding law and negotiate prices with only a one-year certification of the credits from DEP.
7. Trading is not a panacea to help agriculture meet compliance levels with funding from treatment plants. Very different compliance measures exist for these different sectors and while trading may offset agricultural costs it will not provide the large sums of money necessary to help agriculture meet their reduction levels.
8. Point-to-point trades between treatment plants are fairly simple. Compliance monitoring by plants will verify exactly the amount of reductions and available credits from those plants that operate below their limit. DEP is tacking a 10% surcharge to these credits adding another impediment to potential point-to-point trades.
9. Stream specific TMDL standards are being developed for locally impaired waterways. These nutrient reductions will be lower than Bay requirements and are not eligible for trading, forcing construction of upgraded treatment facilities. This will preclude trading for Bay credits if you have to achieve much lower limits for local impacts and treatment is the only solution.
10. Engaging in trading may make more sense for those plants in Phases 2 and 3, and in no-growth areas without the need for other environmental upgrades.
11. Pennvest has authorized up to $50 million to buy and sell credits. Should they become the state trading bank?

The full PMAA trading issues paper is attached for your review. Thank you for the opportunity to testify today.

# PMAA COMMENTS ON DEP TRADING PROGRAM
**August 2008**

## Background

The Pennsylvania Municipal Authorities Association (PMAA) represents many of the wastewater treatment plants that will be required to meet stringent new discharge standards for nitrogen and phosphorus as delineated in DEP's Chesapeake Bay Tributary Strategy.

On September 10, 2007, we received a letter from DEP Secretary McGinty to the editor of PMAA's magazine, *The Authority,* in which the Secretary expressed concern at the lack of interest being shown by municipal authorities and local governments with DEP's nutrient reduction credit trading program. The letter expresses their opinion on the advantages (primarily financial) associated with the purchase of such credits in lieu of physical upgrades to municipal wastewater treatment plants for achieving the necessary nutrient reductions to protect the Chesapeake Bay.

This editorial submittal from DEP on trading prompted us to release this paper outlining concerns our members have, and that have been brought to DEP's attention, on the trading program.

## Issues and Concerns About DEP's Nutrient Trading Program

PMAA has worked diligently with DEP and all the impacted entities for the past three years to adopt solutions for Pennsylvania to meet its nutrient reduction goals. We have been actively involved in the Secretary's Bay Steering Committee, the Point Source Workgroup and the Trading Workgroup. The response of DEP has been positive in many areas, but some fundamental obstacles remain, especially in the trading program.

PMAA continues to believe trading may be a viable solution to meeting nutrient reduction goals; however, there are several reasons why authorities and municipalities are finding trading, in its current form, to be difficult to implement.

It is noteworthy that regulated authorities and municipalities have responded with clear and reliable solutions to the nutrient removal requirements of the Bay Strategy that will ensure compliance for the next 20 or more years. In fact, treatment plants will be the first sector to achieve widespread compliance with the reduction goals set for them in the Strategy. Their responsible solutions have largely been capital improvements. These decisions were made by professional managers, board members, engineers and financial consultants considering all responsible alternatives.

To the extent that nutrient trading has played a minor part in these solutions is mostly due to the limitations we currently see in the DEP trading program and other logistical considerations. The significant factors in many of these decisions are summarized in this document.

1. **A Good Approach?**
   There are 63 Phase 1 wastewater treatment plants, the largest in the region, that need to reduce nutrients in the next 3-5 years. DEP notes that only two of them have indicated they will consider trading as an option. The question one must pose is that if this is such a good option, why didn't more plants embrace it? There are several answers to this.

   Many large plants are in growth areas and will need to expand for future capacity, or they must upgrade to meet new discharge requirements, or replace outdated infrastructure and equipment unrelated to nutrients. The ability to add nutrient reduction equipment during other facility upgrade projects provides a coordinated and cost effective approach to installation as part of a bigger project. Furthermore, the purchase of credits simply applies to nutrient reductions, not to any other environmental requirements treatment plants must implement.

   In December 2006, these plants received a letter which stated that trading should be considered as an option. No detailed information on trading was presented by DEP to these plants. No in-depth packet of information was attached, and the three trading roundtables conducted by DEP were actually held a month after the date when plants had to turn in their implementation plans.

2. **Bidding Limits**
Any purchase of goods, supplies or services by municipal entities in Pennsylvania that costs more than $10,000 must be advertised and bid according to state law, a law designed to protect the expenditure of public monies. The purchase of nutrient credits clearly fits this criterion and purchases will surely exceed the $10,000 price limit. However, the simple purchase of credits from a privately managed nutrient trading website does not meet state bidding requirements and actually will put public entities in violation of these provisions. This point has been made to DEP for the past two years yet we have seen no movement to address this concern.

It should be noted that this approach does not preclude municipal entities from purchasing credits, but the detailed procedural requirements, the costs of the advertising and bidding process, and the contractual agreements do not make this a simple task for either buyers or sellers.

3. **Availability of Credits**
Concern exists over the amount of credits that will be available for wastewater treatment plants to purchase for reduction needs. As of August, 2008, DEP's nutrient trading website listed a total of 659,448 pounds/year of nitrogen credits as ***potentially*** available (subject to DEP final approval and implementation of the nutrient reduction project or best management practice (BMP). There is no information on how long these credits will continue to be available in the future. It should be noted that out of the 29 types of projects that could potentially generate credits, 22 of them are for the removal of chicken manure. Only 4 involve a BMP on cropland.

If the first 63 of the 184 "significant municipal" dischargers (i.e. those that contribute the most nutrients to the Bay) were able to opt for trading, they would need an aggregate of 6.4 million pounds per year of nitrogen credits. The entire 184 dischargers would need 7.5 million pounds per year. The supply of credits in the future is totally unknown and is unreliable for long-term commitments.

4. **Cost of Reduction Credits**
Currently, the price for reduction credits is about $5-$9/lb/yr, mostly from removal of chicken manure from Pennsylvania's Chesapeake Bay watershed. This exceeds the estimated cost of capital construction/lb which over the life of a bond issue may be as low as $2-$7/lb/yr. At such price differences, buying credits could be much more costly over a 20 year period. It would be financially irresponsible for a municipality or authority to pay more for credits than it costs to upgrade its treatment facility.

Even if the costs were similar, the prudent option would be to pay for a facility with known capabilities and under the full control of an authority or municipality, which would also be a long term asset for the community. Simply put, it is like a mortgage on a house: there is a significant upfront cost (paid with borrowed money) which is paid back over time at a modest monthly rate through your mortgage. Debt service on bond issues works the same way. In contrast, purchase of credits each year is like renting; no long term benefit accrues.

5. **Control Over Permit Requirements**
Trading relies solely on the ability of non-point entities, particularly agricultural operations, to annually meet their baseline requirements for reduction and then go beyond these to create nutrient credits they can sell. These have to be certified on an annual basis by DEP. Nutrient credits are subject to many outside influences, including the changes in weather (drought, flood, snow cover), cost of supplies, crop commodity price fluctuations, ongoing oversight of the best management practice that generates the credits, regulatory oversight and contract conditions. All of these factors can affect the number of farmers willing or able to participate in the program each year.

Conversely, wastewater treatment plant owners that have fixed permit discharge limits know exactly what limit they must continually meet, can design their plant accordingly, finance the construction and control the operations for the life of the plant. There is little uncertainty or reliance on potentially hundreds of agricultural entities to continually produce the needed credits.

6. **An Unwieldy Process**
Trading does not need to be as complicated as the program currently exists. From the outset, PMAA and others have asked DEP to establish a nutrient reduction credit "bank" whereby generators of credits (e.g. farmers) could deposit/sell credits and those in need of credits (e.g. authorities, municipalities, or developers) could withdraw/buy

them. Deposits and withdrawals could be done fairly simply. A bank administered by a state entity would also preclude the need for bidding, since the transaction would be government to government.

This approach would allow contributions to the "bank" to be approved by DEP, the Department of Agriculture, the conservation districts, or other recognized governmental entities ensuring the sales price would be used to generate the highest value reductions from the most beneficial best management practices. This would be a simple approach to reductions, give a level of confidence to both those paying for, and those delivering reductions, and occur without state bidding law restrictions. It would also allow for the reductions to include credits from point sources that are operating below their reduction caps. Finally, it would allow the setting of fair prices without the worry of fluctuations in the market, and help ensure long term compliance from the credit generators. It should be noted that Pennvest has approved up to $50 million to buy and sell credits, which could potentially set them up as the "bank."

While initially expressing interest in this approach, DEP instead chose a "market-based" approach whereby buyers and sellers are pretty much on their own to deal with each other and to make whatever contractual arrangements are needed (subject to DEP review and approval) to accumulate enough credits to satisfy the buyers' needs. While DEP has provided a web-based platform (Nutrient Net) for available credits to be posted on-line, this does not eliminate the need for buyers and sellers to make their own contractual arrangements. Also, DEP has not yet been able to provide a generic trading contract document to be used for such transactions, nor to satisfy the state law bidding requirements.

The current approach has produced very few trades (4 in 3 years) and has not allayed any concerns over reliability of cost or supply in the future.

7. **Compliance Issues**

Trading has been portrayed as a method to enhance agricultural compliance largely paid through the purchase of credits with public money from wastewater treatment plants. Several concerns surround this concept:

- wastewater treatment plants are required by permit to meet their discharge requirements,
- with the exception of large animal feed operations (CAFOs) which will be under permit, most of the agricultural reductions that will be needed will be voluntary, spurred by the ability to secure money in credit trading from other sources; most likely wastewater treatment plants and land developers,
- this approach puts no regulatory burden on the sector most responsible for nutrients and sediments (agriculture produces 49% of the nitrogen runoff, 63% of the phosphorus runoff and 72% of the sediment runoff) - it simply "encourages" voluntary compliance using funds from another impacted source,
- the potential exists that wastewater treatment plants, through contracts for credits, might actually become responsible for the production of these credits from non-point sources, something they have no expertise in or little desire to become involved in, further confusing the lines of authority, responsibility and compliance that this trading system has created.

8. **DEP Takes 10% Off The Top for Point-to-Point Trades**

DEP's nutrient trading policy states that DEP will hold onto 10% of each credit trading transaction in order to account for uncertainty in the ability of credit generators to actually live up to their contractual responsibilities. Therefore, a buyer would need to pay for 10 credits while receiving 9. While this may be somewhat warranted for trades between municipalities and farmers, it should not apply to trades between point sources, which through regular compliance monitoring verify on a continual basis what they are reducing. This 10 % add-on simply creates another impediment to the trading process.

9. **TMDL Situations Preclude or Discourage Trading**

Municipal dischargers subject to localized nutrient reduction requirements, resulting from DEP's Total Maximum Daily Load (TMDL) determinations for the local watershed, *will not be able to purchase credits in order to comply with their local nutrient limits* (current DEP position). While this is technically and legally valid, there are a growing number of authorities and municipalities that will not be able to enter into trades because of this. On the other hand, most dischargers in nutrient TMDL situations will need to reduce nutrients to <u>far lower</u> levels than called for in the Chesapeake Bay Tributary Strategy. In other words, more stringent local stream TMDL requirements for nitrogen and phosphorus reduction can only be met by physical removal (plant upgrades) rather than trades.

Also, DEP's trading policy will not allow these more stringent dischargers to sell "excess" credits within the context of the Bay Strategy (allowing reductions to apply to both situations, since they will be far below the Bay requirement) in order to offset the huge costs of meeting TMDL-based limits.

10. **Future Concerns**
    Wastewater treatment plants deciding to fully or partially use trading for nutrient reductions face a long and potentially uncertain future regarding availability and cost. By permit, their discharge reduction must be met at the plant, or offset by credits. While there is a good degree of certainty on upgrade cost, and ongoing operations at a plant, no such guarantee exists for future credits. Even if a plant were to enter into a long-term contract for credits, DEP would only certify the credits on an annual basis, leaving the plant in the untenable position that future credits would require some degree of faith, or contractual agreements enforceable by the courts.

    The decision to forego construction and purchase credits also forces an authority or municipality to recognize that this is an alternate commitment for the anticipated lifespan of a treatment plant, typically 20-25 years. At the end of that useful life span, they have nothing to show for the purchase of 20 years worth of credits, other than annual compliance. (The rent vs. buy issue.) The purchase of credits simply is the purchase of credits, there is no ownership, equity, or benefit of a long term investment in a facility which may be necessary to meet other needs, such as growth, future regulations, and TMDL limits facing the community.

11. **An Unfunded Mandate**
    Local governments view the Bay Strategy as an unfunded mandate impacting many sectors. Particularly troubling is that while the Bay Agreement has been in place since 2000, DEP never engaged the legislature to help solve, or fund, this critical regional problem. The shifting of money from one impacted sector to the other does nothing to alleviate the need for federal and state government to help fund necessary environmental improvements. In fact, the need for a federal and state funding role was clearly articulated in the October 2004 report from the Blue Ribbon Finance Panel convened by the Chesapeake Executive Council.

## Conclusion

In conclusion, PMAA does not believe trading is a simple solution to a complex problem. We are discouraged that after participating for three years in DEP's trading workgroup, there is little resolution to the concerns listed above. To imply that wastewater treatment plants have missed the point on trading belies the fact that those plants are doing exactly what is required to meet their compliance requirements for the Bay.

The creation of a workable trading program has merit as one of many solutions to achieve Bay goals. Parts of the current trading program are workable and innovative, such as the criteria for BMPs, certification of credits, and allowance of a truing-up period. Hopefully, continued future improvements will allow trading to be more fully used as an alternative compliance tool by those who will benefit from it.

PMAA is a strong supporter of the REAP program which provides tax incentives to farmers to produce nutrient reduction credits. We feel this program has strong merit and should be expanded. We also recognize and support the fact that agriculture be given the technical and financial resources necessary to allow them to achieve compliance with Bay goals.

Finally, the creation of a dedicated state funding source to address Chesapeake Bay problems would be a welcome solution. Maryland has leveraged over $1 billion in state grants for improvements to treatment plants. Virginia has provided Bay funds from their general fund of over $700 million in recent years. Pennsylvania needs to recognize that as a major contributor to Bay problems we also need to be a major financial contributor to the solutions. This will involve the investment of state funds, like our sister states, into all entities that are impacted. This includes wastewater treatment plants, agricultural operations, stormwater controls and any other potential sources of nutrient and sediments that could achieve reductions with an adequate funding source.

PMAA will continue to work with its members and all interested parties to find solutions that lead to a cleaner Chesapeake Bay.