

141 Tremont St., Boston, MA 02111

(t) 617-902-2354 (f) 617-902-2349

www.nepga.org

To: Regional Greenhouse Gas Initiative Working Group

From: The New England Power Generators Association, Inc.

Date: November 15, 2007

Re: Auction Design for Selling CO₂ Emission Allowances under the Regional Greenhouse Gas Initiative, Final Report, October 26, 2007 (Report).

Pursuant to the request for comments issued by the Regional Greenhouse Gas Initiative Staff Working Group, and in response to the above referenced Report, the New England Power Generators Association, Inc. ("NEPGA") hereby respectfully files these comments.¹ NEPGA's member companies represent approximately 23,000 megawatts of generating capacity throughout New England. NEPGA's mission is to promote sound energy policies which will further economic development, jobs, and balanced environmental policy. NEPGA requests that all further correspondence, communications and other documents relating to this matter be served upon the undersigned as follows:

Christopher P. Sherman, General Counsel
New England Power Generators Association
141 Tremont Street
Boston, MA 02111
(617) 902-2354
csherman@nepga.org

I. BACKGROUND

The Regional Greenhouse Gas Initiative (RGGI) is a cooperative effort by nine Northeast and Mid-Atlantic States to design a regional emission reduction program covering carbon dioxide emissions from power plants in the region. Beginning in 2009, emissions of CO₂ from power plants in the RGGI states would be capped at current levels, with the cap remaining in place until 2015. The states will begin reducing emissions incrementally over a four year period to achieve a 10 percent reduction by 2019. While the RGGI Model Rule requires states to

¹

The views expressed in these comments do not necessarily represent the positions of each of NEPGA's members. In addition, nothing in these comments should be deemed to waive any rights that NEPGA or any of its members may have to challenge the administrative, procedural or substantive validity of the proposed regulation.

allocate no more than 75% of allowances to generators, most states have announced intent to auction 100% of their allowances. Therefore, affected generators will need to acquire one CO₂ allowance under the CO₂ Budget Trading Program for every ton of CO₂ emissions from the facility. On October 26, 2007, RGGI released the above-referenced Report containing sixteen recommendations for the implementation of the regional allowance auctions which will govern the manner in which generators can acquire CO₂ allowances to comply with RGGI.

II. COMMENTS OF NEPGA

NEPGA supports properly implemented national measures to stabilize and then reduce anthropogenic emissions of CO₂, consistent with other energy policy interests. However, in the absence of a federal program, RGGI must be implemented in an economically efficient manner that does not compromise the integrity of the competitive energy markets or the economy in New England. The restructuring of the New England market has been the product of many years of detailed negotiations and discussions among a wide range of market participants: utilities, regulators, customers, generators and other stakeholder groups. Among the benefits of the competitive market system has been substantial new investment in efficient generating plants. These units are cleaner and more efficient, so emissions of key pollutants have gone down even as electricity consumption throughout the region has increased.² NEPGA is concerned that compliance with RGGI may interfere with ongoing progression that is being made to improve generation efficiency and reliability. The optimistic assumption of complementarities between electricity productivity and CO₂ abatement ignores the very real possibility that firms may face a tradeoff between pollution-saving innovation and general innovation.³

NEPGA's comments contained herein pertain only to the regional auction format envisioned by the Report. The substantive recommendations and positions taken by NEPGA in this document have no relevance to existing or subsequent state auction proposals, as NEPGA's positions on individual proposals are unique to each such design.

1. RGGI Must Closely Monitor the Auction for CO₂ Allowances in Compliance With RGGI to Prevent Detrimental Price Increases or Bulk Power System Disruptions.

NEPGA remains concerned with the rapid progression of the initial auction implementation and disagrees with the general premise that RGGI is a "cap and trade" program similar to other emissions programs implemented by federal and state authorities. The Environmental Protection Agency defines a cap and trade program as follows:

Cap and trade is a policy approach for controlling large amounts of emissions from a group of sources. The approach first sets an overall cap, or maximum

² Despite the increase in generating capacity, New England facilities have reduced the emissions of NO_x by 32%, SO₂ by 48% and CO₂ by 6%.

³ Wing, Ian Sue; Induced Technological Responses to Environmental Regulation, (June 2007)

amount of emissions per compliance period, for all sources under the program. The cap is chosen in order to achieve a desired environmental effect. Authorizations to emit in the form of **emission allowances are then allocated to affected sources**, and the total number of allowances cannot exceed the cap. Individual control requirements are not specified for sources; instead, sources report all emissions and then surrender the equivalent number of allowances at the end of the compliance period.⁴

The obvious distinction drawn between a cap and trade program and RGGI is that under the proposed RGGI program there is no allocation of allowances to affected sources. Additionally, because there is no commercially available emission reduction equipment that is available for significant reductions of CO₂ from electrical generating facilities, by practical exclusion the RGGI program is specifying the purchase of allowances as the only mechanism for regulated sources to manage their carbon emissions. Therefore, the report should recommend RGGI to closely monitor the auction to prevent detrimental price increases or bulk power system disruptions.

2. The RGGI Auction Should Use A Straightforward Auction Style Consistent With the Established Competitive Markets.

NEPGA agrees with the Report recommendations to use a uniform-price auction format; the clearing price for the auction being the value of the highest rejected bid. This auction format provides simplicity and relative transparency. The uniform-price auction is also familiar to the electricity sector, as it is the auction format used in most Independent System Operator (ISO) electricity auctions. NEPGA does not believe there is a benefit to changing the type of auction from one auction to the next. Our experience with auctions suggests that an optimal design is one that is simple, with rules and structures that are easily understood and familiar to the participants. Creating multi-formatted auctions or shifting auction designs from auction to auction creates confusion and inefficiency.

NEPGA encourages multiple round auctions, particularly in early auctions prior to the development of a vibrant secondary market, as a means to improving price discovery. Since there is no technology-based cost to set a value for allowances, it is much more likely with CO₂ allowances than with SO₂ or NO_x credits that the markets will take some time to equilibrate around the 'market price' of carbon. In that environment, with little or no information regarding price expectations, sealed-bid auctions are not likely to be efficient. In the longer run, sealed bid auctions can work as long as there is a sufficient history of price results, and auctions are held frequently (i.e. at least quarterly) to enable frequent tests of market value.

NEPGA recommends auctions that are consistent in supply, timing and procedure so as to allow for the greatest amount of market transparency and least likelihood of market

4

See, Tools of the Trade: A Guide to Designing and Operating a Cap and Trade Program for Pollution Control; Environmental Protection Agency; <http://www.epa.gov/airmarkets/international/tools.pdf>

manipulation. Auctions should be held quarterly at a minimum, especially if sealed-bid auctions are to be used. NEPGA agrees that the greater frequency will provide greater price discovery and enhanced liquidity without interfering with the performance of a secondary market.⁵

NEPGA agrees with the Report's recommendation for joint and uniform regional versus single-state auctions. In the alternative, allowances purchased in single state auctions, if they are implemented, should be fungible (i.e., they should be usable in any other state to increase market liquidity and transparency). Therefore, NEPGA supports the Report's finding that "Allowances should be completely identical, notwithstanding the state of origin." NEPGA maintains that allowances should remain fungible even if there are one or more individual state auctions.

3. RGGI Allowance Auctions must be Consistent and Transparent to Enable Generators to Adequately Plan for Allowance Acquisitions.

NEPGA agrees with the Report's recommendation 5 that future allowances should be made available four years in advance of their vintage and that auctioning future vintages in advance can assist generators in planning for future allowance investments. Due to the uncertainties of the energy markets, as well as the absence of a functioning RGGI allowance market, generators are currently developing compliance strategies for obtaining allowances and are unable to properly gauge the likelihood of their success upon implementation. This problem transcends the normal market hedging issues that are experienced by generators pertaining to fuel procurement and the existing markets for environmental allowances, as those trading mechanisms are more developed in both the primary and secondary markets. The concern about the nascent allowance markets is electric supply disruptions resulting from a failure to provide an adequate supply of allowances. NEPGA recommends that RGGI remain vigilant for electric supply disruptions, and resulting economic curtailments, and be prepared to interrupt or suspend the RGGI program in such an event.

4. NEPGA Has Concerns about Both the Concept of a Reserve Price and Methodology by which RGGI Imposes a Reservation Price.

There has been significant media coverage regarding whether the RGGI cap has been set too high. The Report suggests the use of a reserve price as one way to address this issue. NEPGA strongly disagrees with the use of a reserve price as a mechanism to address this issue; particularly since a reserve price is a concept that was never contemplated under the original RGGI MOU or the RGGI Model Rule. The reserve price would have the effect of artificially increasing the price of CO₂ allowances and convert the RGGI program to a Pigovian tax.⁶ No other emission auction programs currently have reserve prices, due to the instability that it would

⁵ Auction Design for Selling CO₂ Emission Allowances under the Regional Greenhouse Gas Initiative, Final Report, (October 26, 2007)

⁶ The British economist Arthur Pigou advocated corrective taxes to deal with pollution in the early 20th century based upon the principle that if you tax a product you get less of it. Gregory Mankiw, *One Answer to Global Warming: A New Tax*, N.Y. Times, September 16, 2007.

create in the markets. Therefore, the auctions should be held without a reserve price. If, in the alternative, auctions contain a reserve price, the reserve price should at a minimum be specified prior to or at the time of all auctions.

5. Unsold Allowances from Earlier Auctions should be Re-Applied to the Next Auction.

NEPGA disagrees with the option proposed by the Report for unsold allowances⁷ to be rolled into a contingency reserve account. NEPGA advocates that the full share of allowances, and all allowances that are not sold at the previous auction, should automatically be offered for sale at the very next auction so as to maintain proper market signals and adequate liquidity. The goal of RGGI should be to establish a market value for allowances so that private interests and private capital can then produce lower-carbon outcomes consistent with the market value. There is no need to put artificial constraints on price variations from auction to auction. Under no circumstances should unsold allowances be retired. Mechanisms that serve to artificially manipulate the allowance market supply and the overall allowance cap will add to business uncertainty and allowance price volatility.

6. Eligibility Requirements for Auction Participation Should Not Become a Barrier or Place an Unnecessary Additional Cost to Generator Participation.

NEPGA is particularly concerned with the possibility of generators being foreclosed from the allowance market as a result of business activities beyond the control of a particular CO₂ source unit. While applicants should meet the minimum requirements clearly set forth in auction guidelines, the requirements must be objectively outlined and must reflect the reliability needs of the bulk power system. The recent business climate, particularly in the energy sector, has been turbulent and unpredictable, and is likely to continue in such a manner for the foreseeable future.⁸ Generators that don't qualify to participate in the RGGI auctions will be forced into the not yet established secondary market with less liquidity, price discovery and premium pricing. As a result, there is a real possibility that a generator may become uneconomic as a result of conditions that are not reflective of the unit's true marginal cost or environmental efficiencies. Therefore, NEPGA maintains that RGGI generators should automatically qualify, with reasonable credit requirements, for participation in all allowance auctions because of their role in ensuring reliable generation for New England.

⁷

The Report has identified two options for what to do with unsold allowances (1) unsold allowances can be rolled into a contingency reserve account; or (2) all of the unsold allowances can be rolled into the next auction.

⁸

According to the Euler Hermes ACI Business Failures Index, the economic downturn that began in 2007 will increase risks for companies and higher bad debts, leading to a sharp increase in the number of U.S. business bankruptcies this year. Traci Purdum, *Cover Your Assets, Providing Credit To Your Customers Is A Good Thing -- Until They Stop Paying*, Industry Week (October, 2007)

7. A Federally Administered Joint and Uniform Auction For Allowances Will Eliminate Issues of Leakage, Economic Parity and Provide the Most Effective Reductions in Carbon Emissions.

NEPGA believes that the most effective way to address carbon emission reductions is to develop a national, economy-wide program. There ought to be a sunset provision in the RGGI rule that allows for its elimination and replacement with another rule should a federal program be implemented in the future. A regional program, by virtue of the small percentage of global emissions from the limited geographic size, cannot make significant impacts to the overall goal of reducing the amount of global greenhouse gases. Additionally the report should recommend that states advocate for a provision in any national program that allowances and offsets procured under RGGI will be recognized by the national program at a 1:1 ratio.

8. Pilot Auctions Should be Held Prior to the Implementation of Live Auctions for Participants.

The Report indicates that the recommendations contained therein were largely based on experimental economic methods (UVA using students to simulate auction participant behavior) and insights gleaned from economics literature. There has been a consistent request from the regulated entities that “pilot auctions” be held with staff from companies that own CO₂ budget sources, prior to the first auction. The pilot auctions would enable both market participants and states determine how the auctions are likely to perform under varying rules and market conditions. NEPGA supports the recommendation to hold “pilot auctions.”

9. RGGI Market Monitoring and Stakeholder Efforts should be Consistent with Existing ISO Activities.

NEPGA strongly believes that manipulative market behavior can be mitigated through well-designed market monitoring; strong sanctions and penalties; and the disclosure and elimination from future participation of any entity determined to be attempting to manipulate the process in any way. The Report should recommend that draft RGGI auction rules be developed in an expedited manner and published for public comment. These rules should specify clear lead jurisdiction for enforcement and modification of the auction rules. It should be readily apparent to all auction participants what entity has lead jurisdiction as an external market monitoring function and set forth explicit procedures for auction oversight.

NEPGA requests that the Report also recommends that RGGI, Inc. or the appropriate lead jurisdictional entity implement a comprehensive stakeholder process within the RGGI auction program similar to the stakeholder process utilized in the New England electricity markets. The working relationship between the ISO-NE staff, management, and board, and their willingness to meet with electricity market participants and stakeholders has fostered an atmosphere whereby the respective organizations can communicate their particular expectations for and needs from the electricity market. The stakeholders in the RGGI program should have a similar arrangement whereby the RGGI administrators receive feedback on the status of the CO₂ allowance market and implement timely changes. Therefore, the Report should also recommend

that a “market monitor” be established and market monitoring rules be developed with stakeholder input.

10. NEPGA Encourages RGGI to Articulate the Auction Goals in a “Statement Of Intent” That Includes a Standard of Conduct to Protect the Economic and Reliability Needs of Affected Generators.

The overall goal of regulations to limit carbon emissions is an important one and should remain the focus of the initiative, but RGGI cannot ignore the fundamental market operations that are critical to the reliable operation of the bulk power generation system. The purpose of the RGGI program is “to stabilize and then reduce anthropogenic emissions of CO₂, greenhouse gas, from CO₂ budget sources in an economically efficient manner.”⁹ Given the absence of compliance options offered by the proposed program, and the unavailability of back-end emission control technologies, many generating units that are essential for electric reliability could be forced to curtail operations or shut down completely. As stated previously, NEPGA recommends that RGGI remain vigilant for electric supply disruptions, and resulting economic curtailments, and be prepared to suspend the RGGI program in such an event.

11. RGGI Should Evaluate The Performance Of The Auction On An Ongoing Basis As Part Of Their Administrative Oversight Of The Program.

Prudent policy dictates that RGGI facilitators must closely monitor the ongoing performance of the RGGI program on economic innovation and provide the proper safeguards against unwarranted economic interference. NEPGA strongly recommends that RGGI monitor the impacts of the implementation of the auction process, particularly prior to the development of a vibrant and transparent secondary market, and establish firm parameters beyond which the program will be suspended until reliability returns to the bulk power system.

III. CONCLUSION

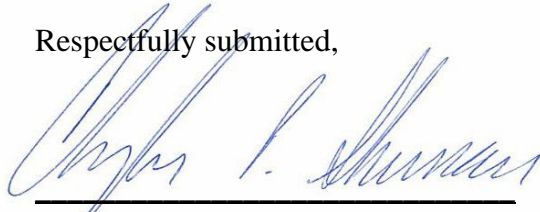
NEPGA is confident that generators can continue to become more operationally and environmentally efficient by incentivizing private investment in new technology. The establishing competitive markets have catalyzed the sector’s ability to accelerate the benefits of an improved environment, while maintaining adequate electrical supply. However, the challenge of maintaining adequate electrical supply is constantly being burdened by regional demand increases, capacity shortfalls and the potential for loss of existing installed capacity from the hasty implementation of poorly developed regulations. Simultaneously, the industry struggles with the inability to develop new generating infrastructure and the inability to comply with regulations through environmental enhancements to existing capacity because of the CO₂ technology limitations, complexities of permitting, and stakeholder and political obstructions. The overall goal of regulations to limit carbon emissions is an important one, but RGGI should not ignore the fundamental market operations that are critical to the reliable operation of the bulk power generation system and a sound regional economy.

⁹

RGGI Model Rule, §XX-1.1

NEPGA appreciates this opportunity and respectfully requests that the Report authors and the RGGI Staff Working Group consider its comments as submitted herein. Please contact me at the information set forth above if I can provide any further information.

Respectfully submitted,



Christopher P. Sherman
General Counsel