



May 22, 2006

To: RGGI State Working Group
Subject: Pace Energy Project Comments on RGGI Model Rule

The Pace Law School Energy Project appreciates the efforts that the RGGI State Working Group and all stakeholders have made to forge a superior regional climate change program. We think that our collective efforts on RGGI will serve not only as a catalyst for an eventual national program, but also as a model and a “laboratory” that will allow a better designed national program than otherwise would have occurred.

We focus here on several key topics: (1) Proposed improvements to the design of the regional cap to assure that it is adequately constraining, (2) Consumer Allowance Allocations, and (3) Provision for voluntary renewable energy programs. Otherwise, we join our colleagues from Environment Northeast in their more detailed comments on offsets.

(1) A Constraining RGGI Cap

Most of our concern about the overall RGGI program relates to the technical inability of anyone to even somewhat accurately predict what will be the baseline, business-as-usual CO₂ emissions level three years hence, not to mention six or nine years. Every single modeled forecast conducted by ICF was heavily clothed in appropriate methodological caveats: “We don’t and can’t really ‘know the future’ with any precision. These are sophisticated guesses. Anything can happen. The results of the modeling are highly dependent on the assumptions.”

Couple this inherent and unavoidable uncertainty with a political imperative that the impact of this program on electric prices not be too great, and the program designers have had strong incentives to construct a program that errs on the side of too little impact rather than too much.

What we have now is a RGGI Model Rule proposal that has in all probability (you can’t ‘know the future’) been constructed with far too much “conservatism” or “softness” and is at great risk of doing nothing (not being binding) when it is rolled out in 2009 and beyond. A “soft landing” for RGGI that allows it to come onto the books without dramatic impact is acceptable. But a RGGI program that rolls out with little or no impact for the first two compliance periods will seem farcical—especially in light of society’s growing concern about global warming.

While we agree that the Model Rule should appropriately build in protections against unanticipated developments that would drive up the cost of the program beyond

“tolerable” levels, we believe that RGGI is flawed because the cumulative effect of its five “cap conservative” features is too likely to undermine the objective of making real reductions:

1. The cap of 121,253,550 (for the original states) is at the high end of what we might reasonably expect emissions to be in 2009. The average for the years 2000 to 2004 for these states is 114,645,056.
2. The “special provisions” for (a) 50% biomass exception; (b) behind the meter exemption; and (c) early reduction allowances, will all further soften the cap. The behind the meter provision in New York alone could represent over 2 million tons of annual “softening”. With each state determining in separate and independent rulemakings how it will handle each of these conditions, no one knows what the actual regional cap is going to be. (This ability of individual states to change the regional cap is, itself, worthy of special concern).
3. The banking flexibility mechanism is a good one, except in this circumstance it may allow the early year softness of the cap to inundate the successive periods, rendering the RGGI cap non-binding for a number of years.
4. The \$7 and \$10 offset “safety valves” provide further protection against the impact of the program on electricity prices rising to what program developers regard as an unacceptable level. These safety valves should allow the program developers to not be “soft” on other program requirements—but this apparently is not the case.
5. The RGGI program does not yet contain any mechanisms to cap leakage. Incremental emissions outside of RGGI to serve load within the RGGI region are on-sector emissions neither capped nor offset, and are thus another form of exemption like the “special provisions” noted above.

We think a great deal of outstanding work has been done over the last several years by the State Governors and Commissioners, the State Working Group, and the Stakeholders and other commenters. This has been a truly Long March and we want to make sure that it realizes its very significant regional, national and international potential. Almost all parties share this aspiration, if in different ways.

We believe that there is a three-part solution that will help resolve the “cap legitimacy” concern:

1. Remove the “special provisions” listed in the second point above, or require that a state permitting them must draw such exceptions or provisions from its apportioned cap. This will clarify for all what the cap is, and avoid the temptation for individual states to unilaterally expand their de facto apportionment.
2. Commit clearly to develop and implement a leakage policy and mechanism that will ensure that power imports do not significantly stifle RGGI’s attainment of a 10% real-world reduction in power sector emissions.
3. Announce now that the RGGI states will formally review the cap level in 2009 and adjust it at that time for the period beginning 2012 in order to assure that the 10% reduction by 2020 will be achieved. An additional “mid-course correction” may also be required. This can be done in a “market friendly” manner by announcing beforehand when and how the determination will be made, thus protecting the interests of those involved in the critically important futures market for RGGI allowances.

(2) Consumer Allowance Allocation

Among the several significant weaknesses or vulnerabilities in the Draft Model Rule, one of the most problematic is the proposal for a common starting point of “at least 25% of the allowances” going to a Consumer Allocation. All allowances should be auctioned or sold on behalf of electric consumers. There are several compelling and independent reasons for total allocation to consumers. At the same time, no sustainable arguments have been forwarded for why the generators should receive any of the allowances—let alone as many as 75% of them.

First, the allowances are held in trust by regulators on behalf of the true, beneficial owners - the public. The public owns the right to pollute The Commons. That society has erroneously allowed private enterprises to pollute freely in the past does not constitute a property right to do so in the future. In fact, it would be far more reasonable to require recompense to the public for past pollution, than to give entrepreneurs free right to do so in the future.

Second, auctioning allowances would be more in line with the Northeast’s reliance on market forces and wholesale competition as a means of determining generator dispatch decisions. From a business point-of-view pollution is just another cost of production. In competitive wholesale electricity—such as we have throughout the RGGI area—this cost of production should be purchased by all the competitors and priced into their market offers. The resulting prices should reflect these true market and societal costs. Offering “costs of production” for free to market competitors is a subsidy that costs the consumers money and distorts the market. There can be reasons for intervening in the market with subsidies, but no good ones have been offered as to why generators should be subsidized in the form of free allowances.

One of the major pluses that consumers were supposed to get out of the competitive restructuring of the electricity market was that for-profit generators would assume the major risks of building and operating electric generating plants. At that time there were a lot of “stranded assets” (ill-advised generating investments) for which the consumers were paying. When these customer-owned plants were sold to private companies, those companies assumed all risks going forward. Such risks specifically include “regulatory risk”—such as new environmental requirements, whether those new risks were anticipated or not. In the case of CO₂, regulation is a well anticipated development, since President George Bush signed, and the US Senate ratified, the Rio Climate Treaty in 1992—long before almost all of these generating plants were privately owned, and 17 years before RGGI commences. To “protect” the shareholders of these private, competitive plants for any risk at all, let alone one as apparent as CO₂, constitutes a subsidy without purpose—a sheer and arbitrary transfer of wealth from consumers to generator shareholders.

Third, the indisputable evidence is that generators will include the price of allowances in their wholesale bid price as an “opportunity cost” whether they receive the allowances for free or pay, and that ultimately, the consumers will pay for allowances in the electricity price even if the allowances are given to the generators for free. As a result, the Draft Model Rule’s proposal to give as many as 75% of the allowances to generators is as inequitable as it is inefficient. Consumers, one way or another, should receive the

proceeds of selling allowances in order to offset in part the price increase they will, in any case, pay. Owners of coal plants, and to some extent owners of oil plants, will tend to lose some net income as a result of RGGI if they have to buy their allowances. But these plants are lower cost providers; they are giving up some of their profits, and for the most part not incurring an operating loss.

The coal plants that will be at greatest risk to lose profits are the oldest, most polluting ones with the highest heat rates. Hopefully the Final RGGI Model Rule will not take the position that the oldest, dirtiest plants somehow need special protection.

The generators have raised the issue of system reliability with respect to awarding allowances. This issue has been discussed at length and hopefully by now has been dismissed. First, the ICF IPM modeling, under a broad range of assumptions, showed almost no coal plants closing. There was reduced operation of some coal plants as the highly efficient combined cycle gas plants partially displaced, in run-time hours, some of the operating hours of the least efficient old coal plants. These are the coal plants that have the highest heat rate and the highest emissions per MWH. But, with rare exception, the vast majority of coal plants maintained their availability.

Even if a number of coal plants or dual-fueled plants were to become economically imperiled, this is not a bad development. Some of these plants are very old and inefficient; obsolescence happens, or at least it is supposed to happen in a market economy. In any case, it is the responsibility of the Independent System Operators (ISO New England, the New York ISO, and PJM) to monitor and maintain system reliability. They all have systems in place for doing so, working with the relevant state public utility commissions. Further, the range of price impacts that RGGI may introduce to the market are virtually insignificant compared to the market vacillations of fuel prices. There are real world issues about availability of dual-fueled units, voltage support, and so forth, but these are all within the normal province of ISO/RTO responsibilities and concerns, and are minimally influenced by the envisaged RGGI initiatives.

Finally, it is important that the proceeds from selling the Consumer Allocation be dedicated to reducing the cost of efforts to mitigate climate change for consumers over the coming decades. We strongly prefer that most of the proceeds be used for energy efficiency programs. Such programs will reduce the cost of future CO₂ compliance by reducing the need for generation and attendant emissions while simultaneously reducing electricity bills. The ICF IPM modeling analysis of energy efficiency along with the REMI analysis conducted for RGGI by the Economic Development Research Group clearly demonstrate the power of investments in energy efficiency to reduce CO₂ while simultaneously reducing bill impacts. We accept that there is also a legitimate concern about reducing immediate customer bill impacts through rebates to customers, as well as concerns about addressing in particular the impacts on low-income consumers. A limited amount of allowance sale revenues should also be directed to helping to develop sustainable supply-side options that do not incur negative impacts on safety, health and the environment.

(3) Treatment of Voluntary Renewable Energy

The voluntary market for renewable energy in the RGGI states provides an avenue for businesses and individuals to reduce their greenhouse gas emissions. In recognition of

the importance of allowing for voluntary action to reduce greenhouse gas emissions in the RGGI states, each State's regulatory agency should incorporate a solution enabling the voluntary market for renewable energy to continue. If such provision is not made as a formal part of RGGI, it is extremely likely that this voluntary market will fail altogether in the RGGI region. Given that SO_x and NO_x are already capped in the Northeast, unless voluntary renewable energy marketers can correctly claim CO₂ reduction credit for their products, they are likely to fail. At least several RGGI states have specifically included voluntary renewable energy development as an integral part of their renewable energy strategies and plans.

We would suggest adding the following two definitions to the RGGI Model Rule:

"Voluntary Renewable Energy Market: The voluntary purchase of renewable energy and/or renewable energy certificates by or for retail customers as a method for reducing their greenhouse gas footprint."

"RGGI Voluntary renewable energy market sales: This is the number of megawatt hours of renewable energy or renewable energy certificates from renewable energy projects located in RGGI states sold to retail electricity customers in a RGGI state."

We would propose adding the following specific language to the RGGI Model Rule:

"Deductions for the Voluntary Renewable Energy Market --The regulatory agency will forecast the anticipated volume of Voluntary Renewable Energy Market sales (MWh) to or for retail customers in their state over the relevant three year time period (beginning 2009), and retire the appropriate number of allowances on behalf of the Voluntary Renewable Energy Market before allocating or auctioning the remainder. After each three year Compliance Period each state will "true up" the difference between the forecast of Voluntary Renewable Energy Market Sales and actual sales by adjusting the going forward forecast accordingly for the next Compliance Period."

Summary

We have appreciated the opportunity to work closely with the State Working Group, the Resource Panel, and the other stakeholders on RGGI. We think that real progress is within our collective grasp, and urge that we continue to seek ways to provide as positive and creative a model for national action as is possible.

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