

States Solicit Comments on Draft Model Rule

March 23, 2006

The participating states in the Regional Greenhouse Gas Initiative (RGGI) are seeking comments on the draft model rule, released today. The model rule sets out proposed program requirements that would govern the operation of the flexible, market-based cap-and-trade program.

60-Day Written Comment Period

Parties interested in commenting on the proposed draft model rule should file their comments in writing during the 60-day comment period. The deadline for submitting comments is May 22, 2006 at 5:00 pm. Comments should be submitted to a central email box, a link to which is provided on the RGGI Model Rule page, <http://www.rggi.org/modelrule.htm>. All comments will be posted on the RGGI website.

Public Stakeholder Meetings

The RGGI Staff Working Group will convene two meetings of the regional Stakeholder Group during the 60-day comment period, as follows:

March 28th, 2006

Time: 9:30 am to 3:00 pm
City: New York City
Location: NY Public Service
Commission
90 Church Street
Lower Manhattan

May 2, 2006

Time: 9:30 am to 3:00 pm
City: Hartford, CT
Location: CT Department of
Environmental Protection
79 Elm Street
Hartford, CT

Those wishing to attend the meetings should follow any pre-registration requirements set out on the RGGI website at http://www.rggi.org/stakeholder_schedule.htm. These are for security purposes only. No transcripts will be recorded to document these

meetings. Stakeholders expressing comments orally at the public meetings are advised to also file written comments.

Specific Areas for Comment

The states have identified some areas where constructive input is especially desired. The Staff Working Group (SWG) especially desires detailed input on the offsets portion of the draft model rule. While general comments are always welcomed, detailed comments will allow the SWG to fully evaluate the need for and viability of proposed alternate approaches, and recommend revisions to the draft provisions as appropriate.

In addition to a general request for detailed comments on the draft offsets provisions, the SWG has also identified the following issues related to offsets for which it seeks comment. This portion of the memorandum is outlined as follows:

- Explanation of the provisions of the draft model rule addressed
- Discussion of the issue
- Request for specific comments, including detailed descriptions of proposed alternate approaches

1. Offsets Additionality Issues.

A. System Benefit Charge Funds. Should projects that receive system benefits charge funding or incentives also be eligible for RGGI offset allowances?

- Draft Provisions. The draft model rule does not allow eligible offsets projects to receive funding or other incentives from any system benefit fund collected from retail electricity and natural gas ratepayers.

B. Renewable Portfolio Standard Credit. Should projects that receive RPS credit also be eligible for RGGI offset allowances?

- Draft Provisions. The draft model rule requires project sponsors to transfer the legal rights to any attribute credits generated from the project (except RGGI offset allowances) to the regulatory agency or an organization designated by the regulatory agency.

1.1 Discussion

The rationale for the draft model rule provisions is that there are existing programs designed to encourage specific market outcomes, some of which

target project types that are eligible for RGGI offsets. Outcomes due to these programs are expected in the absence of RGGI, and have been included in various states' climate and energy policy planning. The draft model rule disqualifies SBC projects and places restrictions on RPS projects, because these projects are unlikely to be additional; i.e., they would happen anyway.

The issue is primarily one of intent. For example, is a project likely to go forward given the current RPS market, or due to significant incentives being provided to the project through a state SBC program? If a project had the potential to receive significant revenue through the RPS market, as opposed to the RGGI offsets market, it may be questionable as to whether the RGGI offsets incentive was what was driving the project.

The current draft model rule provisions require projects to “pick a market” or incentive program, such as the RGGI carbon market or the RPS market, but does not allow them to utilize revenue from both. However, the SWG recognizes that there may be individual projects that would require funding from multiple revenue streams, such as both RPS revenue and RGGI offset revenue, to be considered financially viable.

1.2 Potential Alternatives

Allowing projects to receive incentives or credits from multiple programs would likely require a further “financial additionality” test or other benchmark or performance standard in addition to those in the current draft offsets provisions. For instance, if a project sponsor wished to also receive revenue from multiple non-RGGI sources, this would involve a process for screening the project based on further additionality criteria.

The following potential options have been identified, although the SWG has not fully evaluated the merit or viability of any of these alternative approaches:

- Standardized Financial Additionality Test. Regulatory agency specifies the form of the financial analysis and most of the variables that are used in the analysis (e.g., IRR, NPV, levelized cost of electricity). The project sponsor supplies the project specifications. The analysis would evaluate the viability of the project with and without the projected offsets revenue stream, in comparison to a specified baseline scenario.
- Size Threshold. Smaller projects below a specified size threshold could receive incentives from multiple programs.
- Market Penetration Threshold. Projects employing technologies/practices below a specified market penetration threshold could receive incentives from multiple programs.

- Other Criteria: Other benchmarks that serve as a proxy for likely project non-viability also might be developed for certain types of projects. As an illustrative example, the following might potentially be applicable for landfill gas projects:
 - Date of landfill closure (prior to 1990 – declining gas production as indicator of limited viability)
 - Landfill does not have an existing gas collection system in place

1.3 Resource Needs

Employing these further additionality tests presumes that some party (regulatory agency, regional organization, etc.) is evaluating the market on an ongoing basis so that the tests can be routinely updated through an administrative process. For instance, a standardized financial additionality test would require ongoing market evaluations in order to set the key variables used in the analysis, such as:

- Projected electricity price
- Projected RPS incentive (REC price)
- Projected RGGI offset incentive (offset allowance price)
- Benchmark internal rate of return or other financial benchmarks for certain classes of investors
- Other variables by project type, as applicable

1.4 Specific Questions

- Should the program allow for the capture of incentives from other programs?
- If so, are further additionality requirements warranted?
- Are there practical alternatives that would allow the regulatory agency to adequately screen the eligibility of projects and determine whether it is warranted to allow a project to receive financing, incentives, or attribute credits from other programs, while also retaining eligibility as a RGGI offset? If so, please provide details.

2. Development of Standardized Offset Criteria for the Natural Gas Transmission and Distribution Category

Viability Issues. Can a standardized set of requirements be developed for this offset category?

- Draft Provisions. The draft model rule does not provide proposed requirements for this category of offsets. The SWG has encountered difficulties in trying to devise requirements that utilize standardized benchmarks and/or performance standards to determine additionality. The SWG has also encountered difficulties in providing a high level of assurance for measurement and verification (M&V) of emissions reductions.

2.1 Discussion

The SWG has researched issues related to the design of offsets requirements for reductions in fugitive natural gas emissions from natural gas transmission and distribution (T&D) systems. Significant additional work will be required, in the estimation of the SWG, to fully evaluate baseline and additionality criteria for this offset type to ensure it is compatible with the standardized offsets approach taken in RGGI. The SWG also acknowledges that the development of standardized criteria for this category may not be feasible, and seeks detailed proposals for how to implement standardized requirements for this offset category.

2.2 Description of Potential Natural Gas T&D Offset Category

A natural gas T&D offset would result from a reduction in fugitive emissions from natural gas T&D systems that are demonstrated to be above standard industry leakage mitigation practices (beyond business as usual (BAU)). Natural gas T&D utilities in the United States generally perform a range of functions that directly and indirectly address, minimize, and reduce system leakage. These efforts include programs for maintenance and replacement of T&D pipelines and various inspection and maintenance programs for transmission compressor stations and distribution city gate stations.

In keeping with the standardized approach to offset types undertaken by RGGI, natural gas offsets requirements would set benchmarks or performance standards for current emission mitigation practices and/or fugitive emission levels. This would allow for a standardized evaluation of project additionality.

Along with demonstration of minimum BAU practices and baseline levels, measurement and verification (M&V) of achieved emissions reductions would also be required. The SWG has learned of significant challenges, due to the inherent nature of the operation and maintenance of the natural gas T&D system, to developing baseline, additionality, and M&V criteria.

2.3 Challenges

Measurement & BAU Issues. Based on SWG evaluation, system-wide measurements of T&D gas losses (i.e. on an overall utility basis) are not accurate

enough upon which to base this offset type. Factors such as the challenge of balancing system throughput versus billed consumption and theft of service introduce a high-level of uncertainty that may likely preclude using an overall system measurement scheme as the basis for an offset standard.

Much of the effort of the gas industry to address fugitive leaks in the T&D system (individually and through the efforts of the U.S. EPA Natural Gas Star partnership program¹) centers on intensive, ongoing work at compressor and city gate stations. Utilities commonly perform a range of activities at these locations including, but not limited to:

- Inspection and maintenance programs at gate stations and surface facilities
- Inspection and maintenance programs at compressor stations
- Using turbines at compressor stations in lieu of reciprocating engines (for replacement, upgrades, or new stations)
- Identification and replacement of high-bleed pneumatic devices

Given the decentralized nature of leak detection efforts it would be a challenge to develop a baseline standard that could be applied uniformly to a particular site or set of sites. This is reflected by the best practices encouraged through the EPA partnership and baseline methodologies used for the Clean Development Mechanism (CDM) for compressor and gate stations. The practices and methodologies focus heavily on site-specific characteristics and solutions that argue against the implementation of a standardized approach. Further, the CDM methodologies focus on scenarios with aging infrastructure and a lack of basic leak mitigation practices. In the U.S., natural gas T&D utilities have been engaged in operation and maintenance programs that address system leakage and many utilities have very robust leakage reduction programs. Determining what programs and practices exceed standard practice would likely depend on a site-by-site review and analysis of company facilities, as well as an evaluation of current company-specific leak mitigation practices.

Rate Recovery of Natural Gas Losses. Another significant factor to consider in evaluating this offset type is the fact that most natural gas distribution utilities currently recover the estimated financial value of their annual gas losses through rates. Annual loss targets are typically set and embedded in rate structures and utilities are generally allowed to keep any monies from improvements over and above the targets (and likewise have to incur any costs when they miss the targets). This system, therefore, provides an incentive for utilities to use best practices and minimize their natural gas system losses. How this regulatory incentive interacts with a potential RGGI offset incentive would

¹ The Natural Gas STAR Program is a voluntary partnership between EPA and the oil and natural gas industry working to identify and promote the implementation of cost-effective technologies and practices to reduce emissions of methane.

have to be adequately addressed, in the view of the SWG, before gas T&D system losses can be considered as a viable offsets category.

2.4 Specific Questions

- Are there approaches that would allow standardized requirements to be developed for this category of offsets?
- Are there preferred approaches to monitoring and verification of baseline emissions and emissions reductions that would provide a high level of quantification precision commensurate with the other proposed RGGI offsets categories while also limiting project transaction costs to reasonable levels?
- How could the interaction between regulatory rate incentives and RGGI offsets incentives be adequately addressed?

3. Natural Gas, Oil, Propane End-Use Energy Efficiency Offset Standard Provisions

Eligibility for Existing vs. New Buildings. Should new buildings be eligible under this offset category?

- Draft Provisions. The draft model rule would allow for projects at existing buildings, as well as new buildings in a limited set of circumstances. New building eligibility would be limited to buildings that are designed to replace an existing building and zero net energy buildings. The addition of a broader category of eligibility for new buildings would be considered for addition to the program post-model rule.