Independent Power Producers of New York, Inc.

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IPPNY's Comments on the RGGI's Phase I Allowance Auction Research Report

June 15, 2007

The Independent Power Producers of New York, Inc. (IPPNY) appreciates the opportunity to provide comments on the New York State Energy Research and Development Authority's (NYSERDA) commissioned report, entitled "Auction Design for Selling CO_2 Emission Allowances under the Regional Greenhouse Gas Initiative (RGGI): Phase 1 Research Report." IPPNY is a trade association representing the competitive power supply industry in New York State, including companies involved in the development of electric generating facilities, the generation, sale, and marketing of electric power, and the development of natural gas facilities. IPPNY's members generate almost 75 percent of New York's electricity using a wide variety of generating technologies and fuels, including hydro, nuclear, wind, coal, oil, natural gas, and biomass. All of the views expressed in IPPNY's comments do not necessarily represent the positions of each of our members. Since IPPNY represents a broad spectrum of companies, we anticipate some of our members also will submit comments on their own. In addition, nothing in these comments should be deemed to waive any rights that IPPNY or any of its members may have to challenge the procedural or substantive legality of the RGGI rule or allowance auction or any element thereof.

IPPNY's comments address the following topic areas: (1) markedly limited previous allowance auction experience upon which to draw recommendations; (2) the need to evaluate allowance price control mechanisms; (3) the premature nature of some of the report's recommendations; (4) not withholding allowances from sale if reserve prices are not met; (5) the complexity of the proposed auction structure; and (6) including generators in the auction evaluation and testing process.

Our comments make the following recommendations: (1) test what results would occur when auction participants have no choice but to buy allowances, how high the allowance price goes as a result, and how many bidders do not obtain allowances through the auction process; (2) look at the number of instances and consequences of auction participants not being able to secure enough allowances through the auction because of either scarcity or excessive costs; (3) conduct experiments that phase in the sale of allowances, include a capped allowance price, and examine how many more bidders are able to secure allowances; (4) fully evaluate limiting the allowance auction to generators and allowing the secondary markets to be broader; (5) provide an auction structure that prohibits allowance withholding and protects energy consumers and producers from high costs; (6) develop an auction structure that enables generators to obtain allowances in a straight-forward, fair, and cost-effective manner; and (7) allow generators to provide "real world" input and experience to help "trouble-shoot" the auction model.

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1. The report recommends an auction based upon too limited previous allowance auction experience.

IPPNY is concerned about the report's following statement: "The SO_2 experience and Virginia's NO_x auction experience as well as the experience with the Irish auction of CO_2 allowances in the EU ETS clearly demonstrate that an auction need not disrupt the spot market price signal even if the number of allowances sold at auction is much greater than the quantities traded in the spot market on a daily or weekly basis." IPPNY would like to point out to the report's authors that the minimal experience of auctioning a fraction of SO_2 and NO_x allowances and a minute amount of CO_2 allowances under the Irish auction is not translatable fully to the auction of 100 percent of CO_2 allowances under the RGGI program. Under the RGGI program, the auction of all allowances is the principal vehicle for generators to obtain allowances, while at the same time having no commercially available, back-end emission control technologies to reduce CO_2 (unlike for SO_2 and NO_x).

While emissions allowance auctions have functioned in this country on a limited scale, programs that auction all of the allowances do not exist anywhere in the U.S., and New York's existing rules do not use an auction approach. Outside of New York, auctions have been limited to no more than five percent (5%) of allowances. For example, the Clean Air Act provided for the annual auction of 2.5 percent (2.5%) of SO_2 allowances, in order to provide sources of allowances for new entrants and to support the development of an allowance market, in terms of price discovery, without interfering with the private market. Unlike the RGGI program, revenues were returned to sources and not used to raise money for other purposes. Also, in order to raise revenues to address a state budget short-fall, Virginia conducted a one-time auction of the 2004 and 2005 ozone season NO_x new source set-aside allowances under that state's NOx SIP Call rule. The auction comprised only five percent (5%) of the total state budget and consisted of allowances that existing sources did not have access to anyway.

Even in the US SO_2 program, with only 2.5 percent of allowances being auctioned, market distortions have occurred. As reflected in statements made by emissions traders, the auctioning hindered market development rather than supporting it. Moreover, time and again in the SO_2 program, expectation-led price distortions have occurred in the run-up to and aftermath of even these small percentages of SO_2 allowances being auctioned. These distortions have increased the cost for compliance. The federal auction and the one auction held in Virginia simply cannot form a rational predicate for the auction approach that the DEC's RGGI Pre-Proposal incorporates.

IPPNY also is concerned about the report's following statement: "When considering whether to use an allowance for compliance, a firm will compare the value of allowances to the cost of reducing CO_2." The authors assume that the auction process is supposed to discover allowance prices that approximate the cost of controls, which researchers see as more broadly encompassing options beyond emission control equipment (such as running less, fuel-switching, or demand-reducing measures). However, emission control equipment is not commercially available for CO_2, and running less (when electricity demand is high) and fuel switching (when fuel costs are high) may not be practical or economic options and could lead to electric system reliability problems.

We urge the report's authors to test in their experiments what results would occur when auction participants have no choice but to buy allowances and how high the allowance price goes as a result. In addition, the researchers should identify how many bidders would not obtain allowances through the auction process, bearing in mind that auction participants do not have unlimited resources to procure allowances at any price.

2. Given that generators will need to buy allowances without the ability to recover their costs fully, researchers should evaluate allowance price control mechanisms.

The auction experiments described in the report seem to assume that bidders have sufficient resources to obtain allowances at escalating prices. In fact, the RGGI program's choice to distribute allowances via

auction is based upon the mistaken assumption that allowance costs can be passed on fully to consumers by all generators, dollar-for-dollar. In fact, all generators cannot fully pass these allowance costs onto consumers because the marginal clearing price paid to suppliers in the competitive electric markets does not recover completely each generator's allowance costs. Furthermore, some existing generating facilities are subject to long-term contracts. Because these facilities have no way to recoup the additional costs of the allowance sale approach, the resulting financial consequences could be severe for facilities that are essential to New York's fuel diversity and reliability. We urge the researchers to look at the number of instances and consequences of auction participants not being able to secure enough allowances through the auction because of scarcity or excessive costs.

The report's authors need to conduct experiments that phase in the sale of allowances and include a capped allowance price set at an acceptable level to limit impact on consumer rates, economic development, and electric system reliability (e.g., $0.75 per ton). The researchers should examine how many more bidders are able to secure allowances in the auction at a more reasonable price. Having more bidders able to secure allowances at a reasonable price in the auction helps to ensure that generators will have sufficient access to allowances in order to operate their facilities in a manner that preserves electric system reliability. The auction design cannot simply assume and rely upon generators being able to obtain allowances in the secondary market, since that market will include purchasers that have more market power than generators. If the chosen auction design results in generators not being able to acquire sufficient numbers of allowances, they would need to scale back or cease operations, thereby reducing fuel diversity and electric system reliability. Furthermore, as allowance prices go up, it is likely that the price of electricity also will rise and produce detrimental impacts on energy consumers.

3. Some of the report's recommendations and statements are premature, given that they are slated for review in Phase 2 of the research effort.

IPPNY is uneasy about the report's recommendation #6, which states "Allowance auctions should be open to any party willing and able to meet financial qualification requirements." IPPNY also is concerned about the following statements in the report: (1) "The widest possible participation should be encouraged in order to reduce the potential for collusion and market power in the allowance market" and (2) "There is little reason to believe that the different auction forms will differ significantly in their effects on the liquidity of the spot market, the volatility of prices, or the performance of the secondary markets in general."

These statements are premature and unsubstantiated, since the report makes clear that these instances have yet to be evaluated in Phase 2 of the research effort. The reports' authors have admitted that the recommendation for broad participation in the auction is not based upon experiments in the researchers' economic laboratory but instead upon their literature review.

Auction researchers have expressed the concern that limits on participation in the auction will necessitate limits on participation in the secondary markets and would impact the efficiency of the auction and the revenue it would produce. IPPNY is concerned about the authors' assumption that participation in the auction should not be limited in order to avoid the need to limit the scope of the secondary allowance market, especially since such reasoning is not based upon actual experience in existing emission allowance markets. Under existing cap and trade programs, allowances are allocated directly to generators, and a broader group of allowance owners and purchasers participate in the secondary market. With this existing participation, current cap and trade programs are considered to be highly successful.

IPPNY urges the report's authors to fully evaluate limiting the allowance auction to generators and allowing the secondary markets to be broader, before jumping to conclusions about having broad participation in the allowance auction.

4. Allowances must not be withheld from sale if reserve prices are not met.

IPPNY is concerned about the report's following statement: "What is unclear from previous experience is what the state(s) may want to do with allowances that are not sold because the reserve price is triggered. If allowances not sold due to a binding reserve price are banked by the state, then these allowances could be held as a contingency bank to be sold in auction during periods when prices spike above some predetermined price ceiling. One obvious measure of price levels is the triggers that allow various types of offsets to be brought into the market. The process of rolling allowances from periods of very low prices to periods of extremely high prices would tend to reduce volatility in allowance prices thereby reducing price risk to generators and their customers. Access to emissions offset markets will also help to limit price volatility in RGGI allowance markets."

IPPNY fears that not distributing all allowances will create a shortage leading to electric system reliability problems. Also, the report's authors are assuming incorrectly that the very small amount of offsets use to be allowed under the RGGI program will result in price relief that would allow allowances to be withheld from distribution without causing electric system reliability problems. The RGGI program and the DEC's Pre-Proposal continue to restrict the use of allowances from offset projects to only 3.3 percent under normal circumstances and only up to 10 percent if regular allowance prices rise above certain levels. IPPNY also is concerned that reserve pricing will escalate costs for energy consumers.

As a result, IPPNY urges the auction researchers to recommend an auction structure that prohibits allowance withholding and protects energy consumers and producers from high costs.

5. The proposed auction structure is complicated.

The more complicated the auction structure is, the less bidders will be encouraged to participate. The proposed auction structure of an English clock with a shoot-out round is trying to maximize revenue, but it also is adding complexity and time to the process. The report's authors should examine further their document's observation that the EPA's SO_2 discriminatory, sealed bid auction distributed allowances at near current market prices. IPPNY suggests that the report's authors develop an auction structure that enables generators to obtain allowances in a straight-forward, fair, and cost-effective manner.

6. Generators should be part of the auction evaluation and testing process.

IPPNY is concerned that the report includes, but quickly dismisses, the following statement: "One perspective on this might be that experimental results would be unreliable unless great care is taken to precisely match conditions in the experiment with the empirical situation in RGGI." IPPNY agrees with this statement.

IPPNY is discouraged by how quickly NYSERDA scoffed at the suggestion that RGGI CO_2 Budget Sources be part of the researcher's experiments to help evaluate the auction structure. NYSERDA dismissed this suggestion by stating that RGGI participants would "play games" in the experimental design of the auction. NYSERDA and the auction researchers should not waste an opportunity to get some "real world" input and experience from RGGI participants, who are in the best position to help "trouble-shoot" the auction model. The experience of generators would help transform a theoretical effort into a more useful and sound auction model.

Thank you for the opportunity to provide these initial comments.

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