

Pace University Energy Project
Comments on "Final Report:
Auction Design for Selling CO2 Emission Allowances Under the RGGI"
15 November 2007

The RGGI Auction Design Team has produced an excellent starting point for RGGI's development of an auction for selling allowances. It is time now to proceed with decisions on several key remaining issues, and to start the process of hiring a firm to conduct the auctions. We urge RGGI, Inc. to proceed now since further issues that need resolution will also emerge as the details of the auction are developed. The goal of an initial regional auction in June 2008 is critically important as it will provide the emitters and the market itself time to discover prices and adjust their operating processes and plan ahead.

We also think that RGGI, Inc. should contract with experts on the subject of market power exercise in the energy sector to help provide a market monitoring plan. Obviously, the RGGI auction will be a work-in-progress, especially in the early years, and it should be clearly stated by RGGI, Inc. that the design of the program will be subject to change as experience is gained and as unanticipated circumstances may dictate.

Specific Comments:

- 1) **Reservation Price.** Our most critical concern is that public property (the right to pollute) not be sold at a price significantly below its long term value. RGGI has established two levels of protection against high prices with the two-part \$7 and \$10 offset triggers. We have never been particularly comfortable with them, especially if they are not balanced with a corresponding and symmetrical "low price" or "floor" safety valve. Reservation prices should be used to protect against collusion. As the Report states, reservation prices are also commonly used in auctions to protect the asset from being sold off at a price significantly below its long-term value as determined by the seller.

An "administratively determined" reservation price based upon long-term value (as opposed to one established by benchmarking to the secondary market price), serves also to stabilize the price of allowances, enhancing the long-term purpose of the cap and trade program: stimulate investments in more efficient CO2 reduction technologies. For such prospective investors, a high-end safety valve eliminates high profits from high prices. This can be compensated for by establishing a low-end reservation price that protects against uneconomically low prices.

- 2) **Contingency Account.** We support strongly the use of a "contingency account" for handling any allowances that are not sold in an auction due to not clearing the reservation price. Further, we support the re-offer of allowances at the higher of the two safety bi-valve prices--\$10 at the beginning of the program rather than \$7. (As discussed in early comments, we think the upper safety valves should be well above the \$7 and \$10 prices, but we recognize that this is not the forum for discussing that.) The upper safety valve would be more appropriate since it would allow greater development and experience with offsets in a price zone where they are more likely to be developed and used (between \$7 and \$10).
- 3) **The Auction and Over Allocation in the Cap.** We are greatly concerned that the RGGI cap may be above, possibly well above, business as usual emissions

that the region will experience in 2009. Our emphatic preference is that RGGI, Inc. revisit the cap and lower it if appropriate. Failing that, we recommend retirement of all allowances that fall below the administratively determined reservation price for the first compliance period—another way of treating the problem. After that RGGI should be “on track” with the cap, and at that point we would favor using a Reservation Price and Contingency Account as discussed in points 1 and 2 above.

- 4) **Market monitoring.** Many parties are concerned that there will be successful efforts to manipulate allowance prices in the secondary market. Having done an excellent job of designing the auction, it is now time to attend to possible market manipulation, not just in the secondary auction market, but also as such prices affect the “complementary goods” electricity market. We urge you to hire a market monitoring consultant immediately. Also, we urge you to pursue discussions immediately with the three regional ISO/RTOs, and to work with them and the market monitoring consultant to develop market monitoring requirements, information collection requirements, and possibly institutional roles in this regard for the three ISO/RTOs. Probably RGGI will be more vulnerable to successful market manipulation during the early years. Although RGGI is a “work in progress”, that is no excuse for a relaxed “we will deal with it when and if it happens” approach to something as critically important as market power mitigation and avoidance. The NYISO, ISO-NE and PJM not only have access to lots of confidential data about the RGGI emitters, but also have extensive experience in screening for market power exercise in the electricity market.

Further, we recommend exploration of the possible advantages of requiring bidders and emitters representatives to sign statements that they will abide by the auction and market requirements pertaining to market power exercise, mailing in such statements to RGGI, Inc. This would serve notice that the active participants in the auction, both the company representatives as well as the companies, will suffer legal consequences if they do not abide by important market rules.

Thank you for the opportunity to comment on the excellent start RGGI has made to the design of its auction.

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