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FROM: Northeast Regional Greenhouse Gas Coalition[1]

DATE: June 15, 2007

RE: **Comments on the RGGI Auction Design Phase 1 Research Report**

Introduction

This memo provides the Northeast Regional Greenhouse Gas Coalition's (GHG Coalition) comments and recommendations in response to the Draft Phase 1 Research Report entitled "Auction Design for Selling CO_2 Emission Allowances under the Regional Greenhouse Gas Initiative" dated May 25, 2007.

The GHG Coalition members have participated as official stakeholders to the RGGI process since its inception, participating in every RGGI meeting and workshop and submitting consensus recommendations throughout the entire process. See www.ghgcoalition.com/resources for comments submitted to the RGGI process to date.

The GHG Coalition's comments on the draft report largely focus on the recommendations and the objectives of Phase 2 of the study as provided in the report. According to the draft report, the recommendations are largely based on literature research and limited laboratory experiments conducted by the University of Virginia. This approach concerns the GHG Coalition due to the anticipated financial magnitude of the RGGI allowance market. If the entire RGGI three year compliance period budget for the 10 state region is auctioned, the financial value could likely reach or exceed $2.82 billion.[2]

The GHG Coalition encourages NYSERDA, the project team, and the RGGI states to seriously consider pilot auctions with RGGI affected sources participating prior to executing the first "live" RGGI auction.

In addition, prior to the first live RGGI auction, the GHG Coalition recommends that the RGGI states conduct thorough evaluations of the impacts that allowance auctions could likely have on electricity and fossil fuel markets as well as the over the counter and futures allowance markets that will develop for RGGI compliance units (RGGI allowances and offset allowances). In order to facilitate this, the GHG Coalition encourages NYSERDA, the project team and the RGGI states to actively engage the three Independent System Operators (ISOs) in the RGGI region in the design of the RGGI allowance auctions.

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[1] For more information see http://ghgcoalition.com

[2] This estimate assumes an annual ten state CO_2 emissions budget of 188,076,976 tons of CO_2 and a price per ton range of $3-$5/ton. This results in a market that approaches $560-$940 million per year and $1.69-$2.82 billion for the first compliance period alone (2009-2011).

The GHG Coalition also questions how a substantial allowance auction will interact with the safety valve provisions of the RGGI program. As such, the GHG Coalition encourages NYSERDA, the project team, and RGGI states to add this RGGI design element to the list of issues that will be evaluated in Phase 2 of the study.

<u>Phase 1 of the Auction Study</u>

The following are the recommendations included in the draft report followed by comments and recommendations of the GHG Coalition.

Recommendation 1 - *RGGI may wish to consider a mixed auction program. The first time that a given vintage (preferably defined according to the 3-year compliance period) is auctioned, an English clock with a shootout round using discriminatory pricing should be used. Subsequent auctions of that vintage would use a sealed-bid format.*

> **GHG Coalition Comment**
> Recommendation 1 appears reasonable except that the shootout round at the end of the English Clock auction seems too complicated and unnecessary. Collusion among the participants in the auction is unlikely given the fact that CO_2 Budget Sources compete for electricity market share already and will be competing for allowances as well. Furthermore, the sealed bid structure for subsequent auctions also seems reasonable – assuming that secondary RGGI allowance markets (both over the counter and futures) emerge in a timely fashion, the sealed bid approach should provide efficiencies.

Recommendation 2 - *The auction literature suggests that allowance vintages should be defined according to enforcement or true-up periods (the three year compliance periods) rather than calendar years.*

> **GHG Coalition Comment**
> Recommendation 2 makes sense and the GHG Coalition agrees with this recommendation given the multi year compliance period structure of RGGI and the compliance flexibility this provides.

Recommendation 3 - *Auctions should be held quarterly throughout the vintage period.*

> **GHG Coalition Comment**
> While Recommendation 3 appears reasonable at this time, there should be investigation of more or less frequent auctions and the effects on electricity markets given the significant financial value of the allowances. As noted above, it is very likely that the RGGI market allowance value per compliance period could reach or even exceed $2.82 billion.

Recommendation 4 - *Use credible reserve prices during all auctions. For the reserve prices to be credible, the state must be willing to leave some allowances unsold and be willing to continue to do so until such time as the price rises above the reserve level. To reduce price volatility, the unsold allowances could be banked. Allowances in the bank would be made available during price spikes above a specified price ceiling.*

GHG Coalition Comment

The GHG Coalition does not agree with Recommendation 4. As such, the GHG Coalition encourages the project team to reconsider this recommendation. Support for RGGI was largely the result of the projected low cost impacts of the program (i.e., low allowance prices in the \$2-\$3 range). Depending on the reserve price, the low allowance costs (and subsequently the low cost impacts of the program on the region's economy) may not be realized. Furthermore, the recommendation that the RGGI states should be willing to "hold back" allowances from the market based on the reserve price and then release them to the market to reduce volatility, implies too much involvement in the allowance market by the regulators. This approach will only create additional market uncertainty (because the RGGI regulators may or may not release the allowances into the market), which will likely result in increased allowance prices. Alternatively, the GHG Coalition encourages NYSERDA, the project team, and the RGGI states to evaluate a price cap for the auction, which has worked well for wholesale electric markets (see below).

Recommendation 5 - *Policymakers should consider selling some fraction of allowances in advance of the beginning of a compliance period.*

GHG Coalition Comment

Policymakers should consider selling some allowances as far as possible in advance of the beginning of a compliance period to provide price discovery and liquidity necessary to support the bilateral electricity markets.

Recommendation 6 - *Allowance auctions should be open to any party willing and able to meet financial qualification requirements.*

GHG Coalition Comment

The GHG Coalition does not agree with Recommendation 6. The auction should not be open to any party– unless they are an agent of a CO_2 Budget Source. An auction of allowances on this scale has not yet been conducted, and it makes sense to start slow by limiting the initial auction to CO_2 Budget Sources only (purely trading entities would be able to participate in any secondary trading market).

Recommendation 7 - *The auction mechanism should require strong financial assurance from bidders and should limit bidders to activity no greater than their assurance. In addition, there should be a significant penalty for default and non-payment on the part of winning bidders.*

GHG Coalition Comment

Recommendation 7 is a reasonable and necessary element for any auction.

<u>Phase 2 of the Auction Study</u>

According to the draft report, Phase 2 of the analysis is outlined as follows:

Phase 2 of this study will use the auction form chosen by policymakers based on Phase 1 results to conduct a series of experiments designed to help in crafting the detailed specifications needed to implement an auction of the type chosen. Phase 2 will examine the likely impact of:

- *Secondary markets*
- *Banking and reserve prices*
- *The presence of varying allowance distribution mechanisms*
- *Market power and collusion*
- *Participation by "non-compliance entities"*
- *Revealing bid information after the auction*

Secondary markets
The GHG Coalition is concerned with the potential impacts of a significant allowance auction on not only the secondary RGGI allowance market but also the electricity and fossil fuel markets. Many of the RGGI states have indicated that they will be auctioning 100% of their CO_2 budget. A 100% auction of allowances has never been implemented before in an emissions cap and trade program anywhere in the world. Therefore, the allowance price, secondary allowance market, and electricity market impacts of a 100% auction approach are unknown. As noted above, the GHG Coalition encourages NYSERDA, the project team, and the RGGI states to consult the ISOs in the region actively during Phase 2.

Banking and reserve prices
As noted above, the GHG Coalition does not agree that there should be a reserve price in the auction. Alternatively, the GHG Coalition encourages the project team to evaluate a price cap for the auction. The Federal Energy Regulatory Commission (FERC) has applied price caps to wholesale electric markets. This approach has worked for the wholesale electric markets in the three ISOs in the RGGI region. For example, the New England electric energy market (administered by ISO-NE) and the New York electric energy market (administered by NYISO) operate with stated price caps under FERC approved market rules. In the absence of corresponding cost caps (i.e., price caps on production costs such as RGGI allowance costs), an asymmetrical situation between commodity price and cost will exist that is reminiscent of circumstances which led to the California Energy Crisis earlier in this decade.

The presence of varying allowance distribution mechanisms
The GHG Coalition encourages the project team to evaluate scenarios where some RGGI CO_2 Budget Sources receive a direct allowance allocation at no cost. Perhaps the team could assume that 75% of the total RGGI regional budget is auctioned and the remainder is directly allocated to budget sources. This will likely impact the key auction design choices.

Market power and collusion

Since this is a new market for CO_2 allowances under RGGI, participation by non CO_2 Budget Sources in the auction would result in a market with a high potential for manipulation and abuse. It is a critical issue for RGGI Budget Sources in the absence of clear and transparent market rules to prevent abuse (which will be difficult to have in place at the outset). This is why NYSERDA, the project team, and the RGGI states should, for example, develop clear rules to prevent hoarding of allowances by non-budget sources to the extent they are allowed to participate in these markets.

Participation by "non-compliance entities"
The impacts of non compliance entities participating in the auctions should be thoroughly evaluated in Phase 2. At this early stage with a new allowance market and auction mechanism, allowing any entity (other than CO_2 Budget Sources or their agents) to buy allowances could result in significantly higher auction and secondary market allowance prices for CO_2 Budget Sources. Firms without a compliance obligation will be competing with budget sources for allowances purely based on financial motivations. They will purchase allowances in order to sell them to budget sources at a profit. This can artificially drive up allowance prices, increasing the costs of compliance to above-market prices.

Revealing bid information after the auction
The GHG Coalition encourages NYSERDA, the project team, and the RGGI states to consider the impacts of releasing similar information after the auction that is released after SO_2 allowance auctions outlined below.

1. Number of allowances available for auction;
2. Number of allowances sold;
3. Number of bids (successful and unsuccessful);
4. Number of bidders (successful and unsuccessful);
5. Bid price (highest, lowest, clearing price and weighted average of winning bids); and
6. Winning bidders names on a time lagged basis (e.g., six month after the auction).

Safety Valve Triggers
Finally, as stated above, the GHG Coalition recommends that NYSERDA, the project team, and RGGI states evaluate the impacts of a RGGI auction on the stage one and stage two trigger ($7/ton and $10/ton) provisions of the RGGI program. Depending on the auction frequency, volume of allowances auctioned, and the liquidity of the secondary RGGI allowance market, the stage one and/or stage two triggers may be reached solely in the auctions. NYSERDA and the project team should evaluate whether the methodology (12 month rolling average following a 14 month market settling period) outlined in the RGGI Model Rule for the triggers should be revisited by the RGGI states in light of the allowance auctions.

We look forward to continued participation in the RGGI auction design process and thank you for this opportunity to provide input on the draft report.