

**TO:** rggicomm@gw.dec.state.ny.us  
**FROM:** Northeast Regional Greenhouse Gas Coalition<sup>1</sup>  
**DATE:** November 15, 2007  
**RE:** **Comments on the RGGI Auction Design Report**

## **Introduction**

This memo provides the Northeast Regional Greenhouse Gas Coalition's (GHG Coalition) comments and recommendations in response to the Final Research Report entitled "Auction Design for Selling CO<sub>2</sub> Emission Allowances under the Regional Greenhouse Gas Initiative" dated October 26, 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](http://www.ghgcoalition.com/resources) for comments submitted to the RGGI process to date.

The GHG Coalition recognizes that this document does not represent any one RGGI state's or group of state's perspectives on the RGGI auction design. The GHG Coalition understands that the RGGI states are taking the Report's recommendations under consideration and will try to reach consensus on a single auction design for RGGI over the next several months with the stated goal of holding the first RGGI allowance auction in the June 2008 timeframe. The GHG Coalition encourages the RGGI states to seriously consider stakeholder viewpoints as they deliberate auction design elements, eligible auction participants, and market monitoring and enforcement provisions, among others.

## **Pilot Auctions**

According to the Report, the recommendations are largely based on literature research, experience with auctions in the real world, as well as laboratory experiments conducted at the University of Virginia. There has been a consistent call from the regulated community to conduct "pilot" auctions with appropriate staff from companies that own CO<sub>2</sub> Budget Sources.

The draft Report released in May 2007 recommended that "the first time that a given vintage 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". However, in the Final Report, the recommendation was for a single-round sealed-bid uniform price auction format. Given this significant change, the case for pilot auctions seems especially warranted.

The GHG Coalition strongly recommends that the RGGI states involve the owners of CO<sub>2</sub> Budget Sources in a series of "pilot" auctions prior to the first "live" RGGI auction in 2008. This approach will facilitate learning by the CO<sub>2</sub> Budget Sources as well as the RGGI states with different auction design elements. The pilot auctions would aid market participants as well as

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<sup>1</sup> For more information see <http://www.ghgcoalition.com>.

the RGGI states regarding how the auctions are likely to perform under varying rules and market conditions. This will serve to eliminate some of the uncertainty the CO<sub>2</sub> Budget Sources (and indeed state regulators) face with what looks to be close to a 100% RGGI allowance auction.

### **Regional Auctions**

The GHG Coalition supports the Report's recommendation for joint and uniform multi-state versus single-state auctions. In the alternative, allowances purchased in single state auctions, if they are implemented, should be fungible, i.e., they should be usable in any other state to increase market liquidity and transparency. Accordingly, the GHG Coalition supports the Report's finding that "Allowances should be completely identical, notwithstanding the state of origin". The Coalition assumes that these requirements would apply even if there were single-state auctions.

### **Rules and Enforceability**

The GHG Coalition contends that regional RGGI auction rules (or similar policy statement) be developed in an expedited manner and published for public comment by the RGGI states. These auction rules should not only specify how the auctions will be conducted and by whom, but should also specify the governmental agency that will have jurisdiction to enforce regional auction rules and take action where appropriate.

### **Auctioning Future Vintage Allowances**

It appears likely that a national program will be implemented possibly as early as 2012. The GHG Coalition has long held that when a national program is implemented, RGGI should transition to that national program. If the RGGI states adopt the auction timing and schedule recommended in the Report, RGGI CO<sub>2</sub> Budget Sources will be able to purchase allowances that may or may not have value in RGGI or a future national program for that matter. Due to this uncertainty, future vintage allowances may be significantly discounted compared to current year vintages.

While the Report itself does not directly address this issue, the GHG Coalition encourages the RGGI states to think through the implications of a transition from RGGI to a national cap and trade program, how that transition may occur in light of the proposed longer-term allowance auctions which could overlap with a national program, and the implications on the timing for specific RGGI allowance vintages. At a minimum, as discussed above, the RGGI allowances should be fungible and count not only in any state in a multi-state program but also in a federal program.<sup>2</sup>

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<sup>2</sup> The GHG Coalition continues to believe that RGGI should be preempted by any federal program and thus phased out after any federal program commences. At a minimum, as discussed above, RGGI should be aligned with any federal program to avoid duplication.

## Reserve Price

There has been significant attention recently regarding the level of the RGGI cap and whether it is set too high.<sup>3</sup> Whether intended or not, the Report tees up the reserve price as one way to address this concern. The GHG Coalition questions whether the arbitrary setting of a reserve price is the right approach to address the potential over allocation of RGGI. Conversely, there are potential and possible serious implications if a reserve price mechanism is included and is triggered, such as an unpredictable reduction in the amount of allowances that clear the auction, the disposition of unsold allowances, and the potential economic and reliability impacts.

The GHG Coalition does not support the incorporation of a reserve price in the auction because it does not believe that a reserve price is necessary for a successful auction and it may actually interfere with the functioning of the secondary market. The GHG Coalition, however, realizes that the RGGI states may decide to implement a reserve price. As such, the GHG Coalition provides the following comments regarding setting the reserve price and the disposition of allowances that may not be sold at auction due to the reserve price not being met.

### *Setting the Reserve Price*

The Report recommends that one method for setting the reserve price for a RGGI auction is to set it at a level close to but below the expected clearing price for the auction, which is likely to be very close to the current price for allowances in the secondary market after one develops. Another method for setting the reserve price that was included in the Report was to set it to a level that would maintain a minimum rate of progress in reducing emissions below business as usual, and to maintain the value of investments in new technologies. In this case, the reserve price could grow at a constant rate such as the rate of interest.

Both of these approaches have their challenges. First, setting the reserve price relative to the current price in the secondary market would result in reserve prices that might be very different from one auction to the next. This approach would likely only fuel the anticipated volatility and potential gaming strategies in the secondary allowance market and produce unintended results.

Second, tying the reserve price to some minimum level of progress that would grow at a constant rate is challenging from the perspective of what the justification would be for one particular starting point over another. However, this approach provides a constant rate of increase that could provide a much needed degree of certainty to CO<sub>2</sub> Budget Sources in the auction and could serve as a stabilizing element for the secondary allowance market.

One logical source for determining the dollar amount for the starting point of the escalating value would be the IPM modeling conducted during the RGGI development process and using a similar methodology as that utilized to escalate the RGGI stage one trigger price of \$7/ton.

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<sup>3</sup> The Coalition notes that the concern over whether the cap is set too high, and thus the need for a reserve price, is due to belief that RGGI may be over allocated, which in turn is due to a disparity between natural gas and oil prices that has not existed since 1991. See “Off the Charts: As Oil Soars, Natural Gas Is a Bargain,” New York Times, November 10, 2007, available at [http://www.nytimes.com/2007/11/10/business/10charts.html?\\_r=1&oref=slogin](http://www.nytimes.com/2007/11/10/business/10charts.html?_r=1&oref=slogin). This price disparity could easily reverse itself and should not be the basis for determining auction policy.

These models predicted a starting allowance price range of \$2-\$3/ton. Another alternative would be to set the reserve price at some percentage of the costs of RGGI eligible offset projects.

### *Knowledge of the Reserve Price*

The Report indicates that a reserve price may be publicly announced in advance of the auction, it may be revealed once bidding reaches the reserve level, or it may remain undisclosed by the auctioneer until after the auction is over. If a reserve price is used, the GHG Coalition believes that it should be made public to the auction participants prior to the auction. This will aid in eliminating uncertainty that would increase price volatility.

### *Disposition of Allowances Not Sold at Auction*

The Report notes that allowances not sold due to the use of a reserve price could be retired, rolled forward to subsequent auctions, or placed in a contingency bank. The GHG Coalition contends that allowances should not be automatically retired because this will lead to allowance price volatility.

Instead, the GHG Coalition recommends that allowances should be rolled forward in some fashion to future auctions. For example, depending on the quantity of allowances not sold at any one auction and their vintage, part of the allowances could be placed in a contingency bank and released at some price point in a future auction, while some could be rolled forward to subsequent auctions automatically.

The Report recommends releasing the allowances in the contingency bank if the stage one trigger price (\$7/ton) is reached in the auction. The GHG Coalition recommends that the RGGI states consider a lower price level rather than the \$7 trigger.

### *Price Cap*

Finally, if a reserve price is utilized, the GHG Coalition recommends that a price cap also be included in the auction. A price cap would limit the incentive for speculators to push up the price of allowances at auction. It could be structured in the same manner as the reserve price - some upper price level that would grow at a constant rate.

### **Participation by “Non-CO<sub>2</sub> Budget Sources Entities”**

At this early stage with a new allowance market and auction mechanism, allowing any entity (other than CO<sub>2</sub> Budget Sources or their agents) to buy allowances in the auction could result in significantly higher auction prices for CO<sub>2</sub> Budget Sources. Firms without a compliance obligation (non-CO<sub>2</sub> Budget Sources) will be competing with CO<sub>2</sub> Budget Sources for allowances purely based on financial motivations. They will purchase allowances in order to sell them to CO<sub>2</sub> Budget Sources at a profit or sell them to non budget sources. This can artificially drive up allowance prices, increasing the costs of compliance to above-market prices that would also prevail in any secondary market.

The GHG Coalition recommends that RGGI limit participation in the auctions for the first three allowance vintage years (2009-2011) to CO<sub>2</sub> Budget Sources and their agents only. Non-CO<sub>2</sub> Budget Sources could participate in the secondary market as well as auctions for future vintage allowances from 2012 onward. This will provide a transition to the significant RGGI auction for the CO<sub>2</sub> Budget Sources. It will provide the necessary certainty that CO<sub>2</sub> Budget Sources will have access to allowances at reasonable prices to meet their compliance obligations for the first compliance period.

This transitional approach for the first compliance period will decrease the uncertainty the CO<sub>2</sub> Budgets would otherwise be operating under if non-CO<sub>2</sub> Budget Sources were able to participate in the auctions and increase the likelihood that a secondary market will develop more quickly. CO<sub>2</sub> Budget Sources will likely only enter the secondary market if they have a minimum amount of their compliance obligation locked in. While this amount will likely be different from CO<sub>2</sub> Budget Source to CO<sub>2</sub> Budget Source, offering the 2009-2011 vintages to only CO<sub>2</sub> Budget Sources is a step towards realizing an active secondary market as RGGI is implemented.

### **Auction Limitations**

According to the Report, five possible types of hoarding behavior have been mentioned in RGGI auction discussions:

- Speculation: buy allowances in anticipation of their potential future increase in value so allowances may be sold at a profit.
- Allowance market manipulation: buy allowances not only in anticipation of their potential future increase in value, but to directly induce scarcity and raise the price so allowances may be sold at a profit.
- Electricity market interference: buy allowances with the intent of disrupting the electricity market within the RGGI region.
- Competitive advantage (a.k.a. raising rivals' costs): non-emitting generators buying allowances to raise the cost of generation by emitting generators.
- External compliance: using RGGI allowances as offsets to satisfy voluntary or mandatory carbon reductions by sources outside of RGGI.

The Report's recommendation for a schedule of quarterly auctions, including the advance sale of future vintages, is partly meant to reduce the ability of bidders to "surprise" the allowance market with large, sudden, and unexpected jumps in demand. The Report's recommended schedule of auctions would result in no more than 12.5% of first-time allowances of a given vintage being sold at a single auction.

The Report's recommendations that RGGI may wish to limit single entities to no more than 33% of the allowances for sale at a given auction is a step in the right direction. This constraint would limit a single entity from purchasing more than about 4% of a vintage at a single auction, but would work only if allowances are fungible across all states. This limit would have to be different depending upon the particular state if allowances were not fungible. NYSERDA, the project team, and the RGGI states should seriously consider imposing a price cap to supplement the protection provided by the 33% position limit.

If non-CO<sub>2</sub> Budget Sources are permitted to participate in 2009-2011 vintage year allowance auctions, a 33% position limit in any one auction may not be sufficient. To allow a non-CO<sub>2</sub> Budget Source to purchase 33% of supply in any one auction is neither consistent with RGGI design nor prudent. A separate and lower auction purchase limit would be needed to limit the opportunity to hoard allowances with the intention for resale in the secondary market to CO<sub>2</sub> Budget Sources. The GHG Coalition believes limiting non-CO<sub>2</sub> Budget Sources in a given auction to no more than 2.8% of the allowances for sale at a given auction would provide adequate supply to the secondary market and provide adequate protection against hoarding and market manipulation.<sup>4</sup>

## **Market Monitoring**

Since this is a new market for CO<sub>2</sub> allowances under RGGI, participation by non-CO<sub>2</sub> Budget Sources in the auction would result in a market with a high potential for manipulation and abuse. It is critical for RGGI Budget Sources that there be 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.

The Report suggests that the most obvious step that RGGI should take to monitor the market to prevent manipulation is to coordinate with interested federal and state agencies in the design of criteria and sharing of information. RGGI regulators should adopt rules similar to current FERC rules on price reporting and prohibitions on anti-competitive behavior that apply to electricity and natural gas markets. Secondly, the Report notes that RGGI may want to require that the authorized account representatives should be obliged to disclose the “beneficial ownership” of any allowance holdings. The GHG Coalition supports this recommendation. Lastly, in tandem with market monitoring, RGGI should evaluate auction performance on an ongoing basis.

A critical consideration in designing any market monitoring regime is the remedies that will apply should a violation of the rules occur. Whatever auction formats and rules are ultimately adopted, it should be clear which state or federal agency will oversee the auctions and spot markets, whether auctions will be suspended or nullified if inappropriate activity occurs, and what penalties or sanctions will apply to violators. Decisions in these areas should be disclosed to the public before auctions commence so that potential violations will be deterred and prospective bidders will have faith in the security of the auctions.

## **Pre Qualification and Financial Assurance**

The Report notes that pre qualification and financial assurance of auction participants is essential to the integrity of the auction. Financial assurance mechanisms typically include posting of a bond, deposit, or letter of credit up front that would cover a substantial fraction of the bidder’s ultimate payment should a bidder win the auction.

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<sup>4</sup> The GHG Coalition is making this recommendation based on the experience of the SO<sub>2</sub> auctions. While there are no limits on SO<sub>2</sub> auctions, only 2.8% of allowances of a given vintage are auctioned and have provided enough supply to marketers for a robust secondary market to emerge.

The Report recommends that credit ratings and letters of credit may provide a high level of assurance at very low cost for bidders in the case of RGGI. The GHG Coalition agrees with this recommendation. Furthermore, the GHG Coalition believes that there should also be an allowance purchase limit based on the credit rating and/or financial assurance posted by individual companies so that the entities would be capable of paying for whatever they were awarded.

### **Auction Results**

The GHG Coalition agrees with the Report's recommendations that auction results – including the winning bidders, the total volume of allowances cleared and the auction clearing price should be released as soon as possible after the auction for transparency purposes. This information will facilitate efficient functioning of the secondary allowance market and provide a data point for auction participants to factor in as they prepare for the next auction.