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FROM: Northeast Regional Greenhouse Gas Coalition¹

DATE: December 21, 2007

RE: **Comments on Proposed RGGI Regulation (21 NYCRR Part 507)**

Introduction

This memo provides the Northeast Regional Greenhouse Gas Coalition's (GHG Coalition) comments on New York State Energy Research & Development Authority's (NYSERDA's) proposed regulation (21 NYCRR Part 507).

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 believes that programs to address climate change should be national in scope. The objective of the GHG Coalition throughout the RGGI process has been to provide recommendations so that RGGI could serve as a model for a national program that would have a reasonable likelihood of adoption. Thus, it is essential that RGGI incorporate program elements that can be easily implemented at the national scale. In addition, the GHG Coalition strongly contends that when a mandatory national climate change program is implemented, there must be a smooth transition for RGGI affected sources and related programs. The regulatory elements of the RGGI program (including implementing regulations at the state level) should be superseded by or aligned with the national regulatory program so as not to have redundant and possibly conflicting programs.

The GHG Coalition's comments on the NYSERDA proposal focus on the following issues:

- 100% auction;
- pilot auctions;
- regional auction;
- auction advisory committee;
- rules and enforceability;
- reserve price;
- participation by "Non-CO₂ Budget Sources Entities";
- auction limitations;

¹ The GHG Coalition members are BP America, Inc.; Conectiv Energy; Consolidated Edison, Inc.; Constellation Energy; Dominion Energy New England; Public Service Enterprise Group, Inc.; Valero Energy; and Waste Management, Inc.

- market monitoring;
- pre-qualification and financial assurance;
- auction results; and
- use of auction revenues.

100% Allowance Auction

The proposed 6 NYCRR Part 242 indicates that NY DEC is proposing to auction nearly 100% of its CO₂ allowances. The GHG Coalition is concerned with the emerging trend in the RGGI states in support of a 100% auction of the state's RGGI CO₂ emissions budget. The regional CO₂ cap is the driver of the greenhouse gas emission reduction benefits of RGGI, not the auctioning of allowances.

The GHG Coalition does not support a 100% auction, particularly at the start of the RGGI program in 2009 and especially if non-CO₂ Budget Sources are allowed to participate in the auctions as well. The GHG Coalition does not support a 100% auction for the following reasons:

1. The impacts on allowance prices and electricity markets are unknown;
2. Participation in the auction by non-CO₂ Budget Sources will likely increase uncertainty for CO₂ Budget Sources and increase allowance prices;
3. CO₂ Budget Sources would operate under increased uncertainty;
4. CO₂ Budget Sources in New York State covered by the RGGI Program would likely be competitively disadvantaged; and
5. The financial impacts of the RGGI program on companies are potentially the greatest under a 100% auction.

As an alternative, the GHG Coalition recommends phasing in the auction coupled with a direct allocation to existing and new CO₂ Budget Sources. The allocation of allowances should be based upon a State defined allowance allocation methodology. Going slowly in transitioning to a substantial auction would permit the auction design to be adjusted if there are problems.

First, the auction should start at a percentage well below 100% in the First Compliance Period (2009-2011). The auction could then increase by a specified percentage in subsequent compliance periods. This phase in should only occur if the comprehensive program review that the RGGI states agreed to in the RGGI MOU concludes that such a phase in is warranted and would not have adverse impacts. This phased auction approach has several advantages, including:

- greater probability that allowance prices will be moderate, while at the same time not adversely affecting the regional electricity markets;
- provides a transitional path to implement allowance auctions into cap and trade programs and provides business certainty to CO₂ Budget Sources;

- provides at least a portion of the allowance value to the companies (through a direct allocation), and can reduce the potential increases in electricity imports into the RGGI region; and
- is more realistic and easier to manage for all stakeholders if the auction design isn't "right".

Second, the auction should only be open to CO₂ Budget Sources or their agents, particularly in the First Compliance Period, to prevent undue market speculation at this early stage. Non- CO₂ 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 CO₂ Budget Sources.

Third, the remaining allowances should be "allocated" to CO₂ Budget Sources based upon a State defined allowance allocation methodology.

Pilot Auctions

NYSERDA indicates that the Auction Advisory Committee will use the information provided by the consultants that developed the RGGI auction report to weigh the alternatives and make decisions about what auction features should be used in each auction.

However, according to the final report from the consultants that developed the auction 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 CO₂ 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 NYSERDA involve the owners of CO₂ Budget Sources in a series of "pilot" auctions prior to the first "live" RGGI auction in 2008. This approach will facilitate learning by the CO₂ Budget Sources as well as the RGGI states with different auction design elements. The pilot auctions would aid market participants as well as NYSERDA regarding how the auctions are likely to perform under varying rules and market conditions.

Regional Auctions

The GHG Coalition supports implementing joint and uniform multi-state auctions as soon as possible, as opposed to single-state auctions. To the extent that single-state auctions are deemed necessary initially, allowances purchased in those auctions, should be completely fungible, i.e., they should be usable in any other participating state without restriction to increase market liquidity and transparency.

Auction Advisory Committee

NYSERDA proposes to develop an Auction Advisory Committee consisting of:

- the President and Chief Executive Officer of NYSERDA,
- the DEC Commissioner and
- the PSC Chairperson.

The Auction Advisory Committee, while a good concept, should include the New York CO₂ Budget Source owners. An on-going mechanism for receiving stakeholder input should be put in place so that auction rules and programs can be developed in a series of iterative discussions with industry stakeholders. Stakeholder advice would also assist NYSERDA in determining program budgets, judging program performance, and overseeing NYSERDA's administration. The Advisory Committee could also include additional groups such as the New York Independent System Operator.

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, explain its monitoring and enforcement plan, and detail the penalties that could apply for violations of auction rules.

Reserve Price

The proposed regulation provides the authority to NYSERDA to utilize a reserve price in any auction – but does not require it. The GHG Coalition does not support the incorporation of a reserve price in the auction because a reserve price is not necessary for a successful auction and it may actually interfere with the functioning of the secondary market by reducing market liquidity.

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.

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 using a similar methodology as that utilized to escalate the RGGI stage one trigger price of \$7/ton. 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.

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.

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 to future auctions.

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-CO₂ Budget Sources Entities”

The proposed rule (section 507.8) defines three categories of auction participants. Prior to each auction, NYSERDA, or its designee, in consultation with Advisory Committee, shall select the category or categories or bidders eligible to participate in each auction: Eligible bidders for an auction may include

- owners of CO₂ budget units located in New York,
- owners of CO₂ budget units located outside of New York but within the RGGI participating States that have final CO₂ Budget Trading rules in place at the time of the auction, and
- other market participants including but not limited to owners of fossil fuel-fired generation units located outside of the RGGI participating state, brokers, environmental groups and financial and investment institutions.

At this early stage, with a new allowance market and auction mechanism, allowing any entity (other than CO₂ Budget Sources or their agents) to buy allowances in the auction could result in significantly higher auction prices for CO₂ Budget Sources. Firms without a compliance obligation (non-CO₂ Budget Sources) will be competing with CO₂ Budget Sources for allowances purely based on financial motivations. They will purchase allowances in order to sell them to CO₂ 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 NYSERDA limit participation in the auctions for the first three allowance vintage years (2009-2011) to CO₂ Budget Sources and their agents only. Non-CO₂ Budget Sources could participate in the secondary market as well as auctions for future vintage allowances from 2012 onward.

This transitional approach for the First Compliance Period will decrease the uncertainty the CO₂ Budget Sources would otherwise be operating under if non-CO₂ Budget Sources were able to participate in the auctions and thereby increase the likelihood that a secondary market will develop more quickly. CO₂ Budget Sources will likely only enter the secondary market to sell allowances if they have a minimum amount of their compliance obligation already locked in or have a surplus. While this amount will likely be different from CO₂ Budget Source to CO₂ Budget Source, offering the 2009-2011 vintages to only CO₂ Budget Sources is a step towards realizing an active secondary market as RGGI is implemented.

Auction Limitations

If non-CO₂ Budget Sources are permitted to participate in 2009-2011 vintage year allowance auctions, a 33% position limit as recommended in the RGGI auction report in any one auction may not be sufficient. 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 CO₂ Budget Sources. The GHG Coalition believes limiting non-CO₂ 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.²

Market Monitoring

Since this is a new market for CO₂ allowances under RGGI, participation by non-CO₂ 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 and the consumers who will ultimately pay the allowance prices 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 final auction report from the RGGI consultants 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 and/or CFTC 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.

² The GHG Coalition is making this recommendation based on the experience of the SO₂ auctions. While there are no limits on SO₂ 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.

Use of the Auction Revenues

The proposal indicates that NYSERDA will utilize the auction proceeds to fund programs promoting the following

- Energy efficiency;
- Renewable or non carbon emitting technologies;
- Innovative carbon emissions abatement technologies with significant reduction potential; and
- the administration of the CO₂ Budget Trading Program and the Energy Efficiency and Clean Energy Technology Account

While the GHG Coalition supports these funding categories, it recommends that NYSERDA include a breakdown (on a percentage basis) of the total expenditures of the auction revenues by category in the final rule.

The GHG Coalition views investments in energy efficiency, renewable, non carbon emitting technologies, and carbon abatement technologies as crucial to the development and deployment of new technologies to reduce CO₂ emissions – but not at the expense of a cost effective CO₂ program. By retaining the MOU language in the regulation, which allows for use of auction proceeds to mitigate ratepayer impacts, the RGGI program will have the flexibility to adjust this investment more efficiently in response to developing markets and technology.

The preferable way to accomplish this objective would be to have the auction revenues subject to New York Public Service Commission (PSC) jurisdiction rather than NYSERDA because of the PSC's special expertise in overseeing the administration of funds related to energy and efficiency and renewables, in addition to its rate impact expertise.

We look forward to continued participation in the New York RGGI process and thank you for this opportunity to provide input.