

## **Michael Bradley (Northeast Regional GHG Coalition)**

### **Talking Points for the April 6, 2004 RGGI Stakeholder Meeting regarding the RFF RGGI Allocation Study**

I want to applaud Dallas Burtraw and others at RFF that contributed to this report for raising these key allowance allocation issues for the RGGI Staff Working Group and the RGGI Stakeholders.

However, the report assumes that the allocation methodology is applied uniformly in every RGGI state, which is unlikely given the implementation history of cap and trade programs in the region.

Furthermore, of equal importance is how the RGGI cap gets apportioned to individual states – which is not touched on in the report. I urge the RGGI Staff Working Group to have a session such as this at the next RGGI meeting regarding apportionment of the RGGI cap to the RGGI states.

### **Auctioning**

1. During the stakeholder process, many stakeholders have recommended that RGGI strive to serve as a model for a national level program. A major auction component to a CO<sub>2</sub> cap and trade program is not viable nationally.
2. There are significant legal obstacles associated with an auction. In fact, state environmental agencies likely do not have the necessary legislative authority to hold an auction, receive auction revenues, and spend those revenues.
3. Proponents of an auction do not quantify the administrative and transaction costs associated with this approach.
4. Establishing a CO<sub>2</sub> cap in the Northeast while neighboring states remain unregulated creates important competitive concerns. An auction approach to allocation, would aggravate these concerns, creating further economic disadvantages for power companies in the RGGI region.

## **Updating Allocation**

The differences in the results that you present—in terms of electricity prices, fuel mix, and emissions—between the updating approach on the one hand and the grandfathering and auction approach on the other stem from the “output subsidy effect” that you assume in the model.

Under an updating allocation you assume that companies will reduce their electricity bid prices in order to gain a greater share of future allocations. This leads you to conclude that the updating approach results in the lowest electricity prices, the highest electricity demand, the lowest criteria air pollutants, and lowest amount of leakage.

My concern in reading the report is that you assume with virtual certainty that this subsidy effect will actually materialize in a meaningful way under real world market conditions. The report assumes a perfectly rational market with ideal competitive structure and actions by market participants. The report does not account for market realities such as: load pockets, transmission constraints, congestion pricing, capacity charges, price caps, and reliability must run units. I think this point merits some additional scrutiny.

The question is what value will a company assign to future allowances earned from increasing production or how far will a company reduce its bid prices in exchange for “potentially” receiving additional allowances in the future. In your modeling you are forecasting allowance prices in the range of \$35 in 2025. (This is in part because you assume no offset availability.) Allowance prices are obviously central to whether the output subsidy effect will manifest itself in a meaningful way because this is the enticement that will drive a company to reduce its prices.

My first comment would be that your allowance prices appear to be on the high side. The second point that I would make is that the future value of these potential allowances earned has a high degree of uncertainty associated with it, which will discourage companies from assigning too high a value to these allowances. I would emphasize that the trade off inherent in the market response you are assuming is an immediate increase in fuel costs, O&M costs, and allowance costs in exchange for future potential earnings in the form of allowances. Companies will tend to discount the value that they assign to these future allowance earnings because of uncertainty about future prices, the time value of money, and the regulatory uncertainty inherent with

a program that may one day be replaced by a national policy. All of these factors will reduce the strength of the subsidy effect.

Also, a company will only receive additional allowances if it increases its “relative” share of the RGGI region’s megawatt hours. If a plant increases its output, it won’t necessarily increase its share of output if demand is increasing across the region. To the extent that your modeling fails to capture these practical dynamics, then it will assign too high a value to future allowances earned and overstate the effects of the updating approach.

I believe in the advantages of an updating allocation, in fact the GHG Coalition supports an updating output-based approach. There are several advantages to an updating allocation in terms of encouraging new cleaner forms of generation and encouraging production efficiency. However, I suspect that the effects that you forecast are largely overstated because of your assumptions about allowance prices and the limits of the model in capturing some of the issues that I have raised.

### **GHG Coalition Recommendations**

#### *State Apportionment Methodology*

1. The GHG Coalition recommends an *updating output based* methodology for the apportionment of the region wide CO<sub>2</sub> cap to the RGGI states.
2. The apportionment methodology should be based on the state’s percentage share of RGGI region electricity generation in order to fully realize the advantages of an output-based allocation to individual electric generating units and maximize the equity between RGGI states.

#### *Updating Allocation to RGGI Affected Units*

1. GHG Coalition supports a fossil fuel neutral, updating, output based allowance allocation methodology with a set aside for new sources. This approach has at least two advantages:
  - a. it creates incentives for companies to operate their facilities as efficiently as possible and
  - b. sends a signal to the market regarding the construction of higher efficiency plants

2. The allocation methodology should not penalize cogeneration – instead it should recognize useful steam output as well as electricity output.
3. The GHG Coalition recommends a consistent approach to allocations across all of the RGGI states in order to avoid distortions in the electricity markets.
4. The GHG Coalition suggests distributing allowances at least 3 years in advance of the applicable compliance period, which will facilitate business planning.