AES North America East
Ithaca, New York 14850

November 15, 2007

To: RGGI State Working Group
Subject: AES Comments – October 2007 Auction Design Report

Attached, for your review, our AES North America East's comments regarding the October 2007 Auction Design Report.

We hope the State Working Group will consider these points in the final auction design created. We appreciate the opportunity to provide comments.

Sincerely,

Chris Wentlent, Director
Regulatory Affairs

***AES North America East Comments on Auction Design for Selling $CO_2$ Emission Allowances Under the Regional Greenhouse Gas Initiative. Final Report. October 2007. Holt, et al.***

AES North America East ("AES") submits the following comments on the final report "Auction Design for Selling $CO_2$ Emission Allowances under the Regional Greenhouse Gas Initiative" (the "Report"). The AES comments address the design and mechanics of prospective auctions as provided in the Report.[1]

**Recommendation 1: Uniform-Price Auction Format**

AES supports the recommendation of a uniform-price auction format where the clearing price for the auction is the value of the highest rejected bid.

**Recommendation 2: Single-Round, Sealed-Bid Format**

AES supports the recommendation of a single-round, sealed bid format. However, additional consideration must be made as to how reliability concerns will be incorporated into the auction design. Specifically, the NYISO in its 2008 Reliability Needs Assessment has identified that, at a minimum, 52,000,000 CO2 allowances must remain in the control of the generation suppliers to ensure the New York Transmission System needs are met. It is highly likely that each RGGI state has a similar requirement. How will this need be addressed in the auction process? Will a separate round, only for supply sources, be conducted first to ensure reliability is met and secondary rounds allowing open participation follow for the remaining available allowances?

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[1] Notwithstanding these comments, AES maintains concerns regarding the proposed 6 NYCRR Part 242 CO2 Budget Trading Program, the proposed 6 NYCRR Part 507 CO2 Allowance Auction Program and the Draft Generic Environmental Impact Statement issued with respect to these proposed regulations (collectively, the "Proposed CO2 Regulations") and will be commenting on them separately. As a result, nothing in these comments should be construed as acceptance by AES of the Proposed CO2 Regulations. To the extent the subject New York State agencies determine to nonetheless proceed with the Proposed CO2 Regulations, including the 100% auctioning of allowances, AES offers these comments without waiver of or prejudice to its position on the Proposed CO2 Regulations. And all comments here are conditioned on the State agencies obtaining the requisite lead authority to conduct the auction, which authority they presently lack. AES also submits that the auction design and mechanics must be part of the Proposed CO2 Regulations; proceeding with the Proposed CO2 Regulations without having completed the auction design is contrary to the New York State Environmental Quality Review Act ("SEQRA") and otherwise is not appropriate.

**Recommendation 3: Separate Auctions for Different Vintages**

AES supports the concept of separate auctions for different vintage years.

**Recommendation 4: Quarterly Auctions**

AES supports quarterly auctions of allowances as recommended in the Report. Market monitoring rules, legally enforceable CO2 allowance instrument development, specific reserve price criteria, and market participant auction test exercises should be completed prior to any implementation of the first auction.

**Recommendation 5: Auction Future Allowances in Advance**

AES supports the Report recommendation for the sale of future vintages at the quarterly auctions. This is particularly important for forward planning to have a mechanism for securing allowances.

**Recommendation 6: Reserve Price**

AES believes this recommendation is a dramatic policy shift away from the normal design criteria of historical cap and trade programs. In fact, depending on how the withheld allowances are reintroduced into the market, the use of a reserve price has the potential to move the basic tenets of the CO2 program from Cap and Trade, to a Floating Cap and Administratively Set CO2 Allowance price, which is not a market-based system. In addition, the concept of a new floating cap and administratively set reserve price at each auction will create a new uncertainty to the electric and CO2 marketplace for energy transactions and long term planning and provides the least amount of protection for energy consumers.

Clarification of the criteria and process that will be used to determine the value of the reserve price is of critical interest to all market stakeholders. In the absence of this information, it will not be possible for the allowance market to function efficiently. The process must be clear and the reserve price should be set by an independent group that has no interest in the revenues gained from the auction. Possibly, the market monitor responsible for the overall market monitoring of the program should lead this effort. Further, once the actual criteria and process is determined, the proposed approach should be reviewed with all stakeholders to fully incorporate any other market concerns.

Clearly any auction reserve price impacts the overall costs of the carbon reduction program. Accordingly, we recommend that if a reserve price approach is implemented, there should also be a cap on the maximum value of any carbon allowance to provide a symmetrical protection to the market participants and consumers. An example of a symmetrical approach would be to use a reserve price set based upon the ICF modeling that was contracted to initially support the RGGI initiative and the minimum reserve price should be a 50% of that ICF value with a maximum value of 150% of the ICF value forecasted for the subject year of consideration. This approach ensures that any outcome does not deviate substantially from the expected financial impacts on consumers that policy-makers utilized to move forward with RGGI.

**Recommendation 7: Unsold Allowances**

Unsold allowances should be rolled immediately into the next auction to avoid price increases that may occur if allowances are artificially withheld from the market. An administrative decision to control when and/or if unsold allowances are re-introduced to the market creates the following market issues:

- Departure from the established allowance caps created in the original MOU utilized in creation of the RGGI Cap and Trade Program.

- A tendency for $CO_2$ allowance prices to increase substantially before banked allowances are re-introduced into the market to control the upward price pressure. Administrative determination of when to introduce banked allowances will create artificially higher prices than the actual supply/demand situation that would exist if banked allowances were not withheld from the market in the first place.

- Inconsistent market signals for trading purposes, investment in existing infrastructure and investment in new infrastructure. Conceivably, a generation resource could be penalized for excellent $CO_2$ reduction efforts because the actual allowance volume to market or reserve price could be changed to create a set allowance revenue flow for other purposes.

**Recommendation 8: Lot Size**

AES agrees that minimum lot size of 1000 allowances supports auction efficiency.

**Recommendation 9: Open Auctions to All Qualified Bidders**

AES disagrees with the recommendation that auctions should be open to all qualified bidders especially until commercially viable control technology is available in the marketplace. Currently, source-specific compliance activities available include fuel-switching to less CO2 intensive fuels, and site-specific efficiency improvements.

Further, the state appears to believe that the regional cap and New York State cap are greater than the respective actual emissions. Assuming without agreeing that this is correct, certain historic CO2 generation emissions data indicates the actual emissions are very close to the established regional cap, and in many states very close to the established state cap. Unfortunately, it takes a relatively small amount of allowances to be withheld by bidders for speculative or other purposes for the “excess” to be absorbed and a highly inelastic CO2 allowance demand to be created. In other words, the RGGI program is highly susceptible to allowance shortages and/or price increases due to either incorrect use of reference years, the retirement of a modest portion of the allowances or from allowances being withheld from the market by one or more pivotal players in the allowance market.

There is also a Report recommendation that no entity be allowed to purchase or take beneficial interest in more than 33 percent of allowances in any auction not withstanding the research team’s belief that hoarding of allowances by non-generators is unlikely. Allowing 33% purchase levels makes it too easy for pivotal CO2 allowance positions to develop. RGGI should replace the 33% cap with a cap that is based upon a market participants own need for CO2 allowances based upon its historic prorated need to consume allowances plus 5%. Furthermore, this limit should be enforced in both the auctions and the secondary market. This would protect against pivotal positions in the CO2 market.

**Recommendation 10: Bids are binding Contracts**

We agree with language in the Report that every effort should be made to minimize the cost of financial assurance, as this represents yet another cost of business without environmental benefit.

**Recommendation 11: Joint and Uniform Auctions**

AES supports the Report recommendation for joint and uniform multi-state versus single-state auctions because of the improved efficiency provided a regional, uniform approach has the proper legal authorization and is otherwise consistent with applicable laws. Bids should be legally binding and enforceable among the states, and one fungible, legally enforceable allowance instrument developed for the entire region.

**Recommendation 12: Market Monitoring**

As recommended in the Report, there should be close cooperation with organizations such as the Federal Energy Regulatory Commission, U.S. Environmental Protection Agency (EPA), NE-RTO, NYISO, and PJM-RTO system operators, and Commodity Futures Trading Commission (CFTC) in designing specific rules to detect any market related issues that could transpire due to the introduction of RGGI. These meetings should take place immediately, include all stakeholders and result in specific rules that are developed and communicated to all market participants in both the auction and secondary market. As noted above, these rules should be designed to avoid the development of pivotal positions by market participants. The Proposed CO2 Regulations and indeed the RGGI program should not be implemented until this critical market protection is put into place.

**Recommendation 13: Disclosure of Beneficial Ownership**

Please clarify what is determined to be "beneficial" and what is the outcome if not beneficial? AES believes that any buyer of allowances should be required to announce this intent ahead of the auction. Furthermore, RGGI should keep an ongoing tally of the number of allowances that have been retired and post this information publicly.

**Recommendation 14: Auction Information Disclosure**

Price transparency is necessary for a secondary market to develop and as such we agree that there should be public disclosure of auction outcomes. So long as clearing prices (and quantities), but not individual bids are made available, price discovery is available to all.

Thank you for the opportunity to respond to the Auction Design report.