



Conservation Law Foundation

Comments of Conservation Law Foundation on the October 27, 2007 Final Report regarding
“Auction Design for Selling CO2 Emission Allowances Under the Regional Greenhouse Gas
Initiative”

Submitted November 15, 2007 by Seth Kaplan, Vice President for Climate Advocacy

The Conservation Law Foundation appreciates the opportunity to offer comments on the final report of the expert consultant group advising the states regarding design of the regional auction of RGGI CO2 emission allowances.

As we said in our comments on the draft auction design report the importance of this work is difficult to overstate. We continue to believe that when history tells the story of the RGGI effort the redefinition of cap-and-trade through introduction of large scale allowance auction will be the story that will be told. The process of shaping and launching RGGI continues part of a critical global and national movement towards recognition of cap-and-trade with auction as a critical tool for regulating and reducing harmful emissions. If we fail to successfully design and launch the auction that critical narrative will falter.

Now, more than ever, god (and the devil) can be found in the details - and the critical details around the design, scale and nature of the auction, the market monitoring of the auction and the precise manner of operation of the auction are now firmly on the table before us.

THE CRITICAL IMPORTANCE OF SETTING A RESERVE PRICE

The Auction Design team appropriately notes the overriding importance of the question of setting and implementing effectively a Reserve Price and this recommendation should be embraced by the States and the regional organization.

It is essential to note that setting a reserve price is, first and foremost, a question of good auction and market design, deterring collusion and ensuring that the market is liquid and operating efficiently.

We also note that if allowances remain unsold (because of failure to reach the reserve price) after several quarterly auctions then a clear signal is coming from the market regarding the lack of value of the allowances, most likely because of a realization that there is an oversupply of allowances – this is especially true after the compliance year for which the allowance is denominated has past. While the idea, discussed in the Auction Report, of putting unsold allowances into a reserve or contingency account (with release if allowance prices reach a pre-determined level) may have merit it is important that we not create a mechanism that will create

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an ever-expanding “bank” of allowances that may or may not come on to the market at some undetermined point in the future.

Some of the (legitimate and correct) concerns that underlay the decision of the signatory states to reject a price cap in the RGGI MOU argue against the contingency account concept – particularly the concern that this could create a market distortion. However, the primary concern that a “hard cap” involving the issuance of additional allowances would undermine the integrity of the cap is not implicated by this proposal.

**IN COMPLETING THE AUCTION DESIGN THERE NEEDS TO BE A FOCUS
ON CREATING AN OPEN AND LIQUID MARKET – RELIEVING CONCERNS
ABOUT RELIABILITY ISSUES**

Many of the substantive concerns that have been raised about the RGGI program, particularly concerns about availability of allowances to meet the needs of generators, can be addressed in large part through the kind of design issues being discussed here. As ISO-NE staff noted at a recent forum, if the auction is properly designed and implemented, it will not have any negative impact on electric system reliability (see LaPlante presentation at http://www.iso-ne.com/support/training/cal_docs/rggi_forum_mtrls_v4.pdf). This happy reality means that the process of auction design and implementation is of great importance in addressing concerns about reliability – as well as ensuring that RGGI achieves its environmental goals and sets good precedent.

It is absolutely critical that the auction be open to all participants who meet pre-stated and reasonable financial assurance requirements

The auction design team correctly notes the essential importance of having an open auction that allows full participation of all parties. As a practical matter this means that the states should reject any effort to extend special rights to generators in the conduct of the auction. It is interesting to ask if such a plan is even possible to implement – as an industry representative noted at the recent Auction Design forum in Albany it is very difficult to clearly define who a “generator” is in the current world given the multiple roles as supplier, wholesaler, retailer and operator of generation that many companies play. As was specifically asked in Albany – when a Hedge Fund owns a power plant is the Hedge Fund a generator? Clearly if one looks at the “interested person” rules of FERC and the ISOs, and how those rules have played out in forums like the New England Power Pool it is easy to see the web of interests that make it very, very difficult (if not impossible) to parcel out such special rights if the imprudent decision to create such rights is actually made.

The fundamental reason for keeping the auction open is to provide the most fluid, dynamic and efficient an auction possible by bringing as many participants to the table as possible – defusing opportunities for market power, gaming and monopsony behavior (or more

accurately oligopsony¹ power). The closed world of large scale electric generation and associated trading is a perfect breeding ground for oligopsonic and collusive behavior by the small number of generators – collapsing the RGGI auction market down into this small pool of participants is an open invitation to gaming.

It is essential nearly, all, if not all states participate in the Regional Auction

One way of defusing this inherent problem of market power and gaming is both to open up the pool of buyers (as discussed above) but also to expand the pool of sellers. The success of the auction and the market that it initiates will turn in part on there being sufficient volume of allowances “in play” with a high degree of certainty around the timing and manner of the release of the allowances. Therefore, it would be optimal if all states engage in RGGI participated in the regional auction – this is even truer if contract restrictions attached to allowances at the regional auction are the backbone of a transparent secondary market.

This means that all regional efforts must be made to shape the auction in a manner that brings the maximum number of states “to the table” – which as a practical matter will mean addressing state-by-state concerns about public procurement and contracting laws in a careful but rapid manner.

We continue to believe that the very different fiscal situations of the states should be taken into account in designing the regional auction mechanism and apportioning financial responsibility for the auction and the Regional Organization

Robust and effective market monitoring of the secondary market will assist in addressing concerns about availability and reliability – we recommend the creation of three distinct layers of market oversight

The experience of the ISO/RTO energy markets demonstrates the essential importance of effective marketing monitoring overseeing auctions of this type. Market monitoring can take three forms: (1) “Real-time” monitoring undertaken by staff of organizations operating the auction (in the ISO/RTO context this is often done by an “Internal Market Monitor”), (2) ongoing monitoring by an outside expert consultant, and (3) periodic (probably no more often than annual) review of the market by an outside expert (often and academic). Sometimes the same individual plays both roles (2) and (3).

We believe that it is essential that all three types of monitoring be brought into play here.

We would suggest that given the level of interest in RGGI it will not be difficult to find an outside monitor who would on a periodic (annual or even less often) basis analyze the operation of the market and provide a completely objective overview and analysis. We suggest this

¹ An online reference work describes an oligopsony as being, “Similar to an oligopoly (few sellers), this is a market in which there are only a few large buyers for a product or a service. This allows buyers to exert a great deal of control over the sellers and can effectively drive down prices.” www.investopedia.com/terms/o/oligopsony.asp.

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monitor should report directly to the constituent RGGI states and not have any direct relationship whatsoever with the regional organization or the operation of the auction.

The second level of monitoring (provided on an ongoing basis by an outside consultant) would provide a clear and objective “window” into the operation of the market, allow for ongoing engagement of issues raised by the periodic review and provide guidance to an internal monitor. Presumably, this ongoing outside monitor would report directly to the board of the regional organization.

The third, and most basic, level of monitoring would involve a “hands-on” market monitor actually on the staff of the regional organization. That monitor should report directly to the Executive Director of the regional organization and would have a specific mission of ensuring that the recommendations of the outside monitor(s) are followed, tracking the operation of the market on an ongoing basis and coordinating with the market monitoring operations at FERC, the ISOs and other relevant regulators and organizations.

Effective deterrence of “Gaming” and “Market Power” requires careful thought about what information is and is not released on a real time (or close-to-real-time basis)

Perhaps counter-intuitively, requests for “price and information transparency” of real time and close-to-real-time data by the generators should be viewed with suspicion because of these market power concerns. Posting long-term contract prices, as this increases the likelihood those participants will exercise market power (through gaming). One case study of this phenomenon comes to us from California where the System Operator (“CAISO”), through the transmission of information via the web based “OASIS” system to market participants, appears to increase the average price of electricity, as does the publishing of emergency conditions.² The likely outcome from a market that provides too much information to participants with a strong incentive to collude and game is to increase mimetic behavior and the potential for implicit market collusion.

There is ample reason to believe that this same behavior could occur in a limited-buyer oligopsony/monopsony situation as readily as in a limited-seller oligopoly/monopoly context and therefore this concern should be very front and center in the market design.

Conclusion

Thank you, again, for this opportunity to comment and we look forward to continuing to participate in the ongoing implementation of this important effort.

² E. Woychik and B. Carlsson, *How Enron et al. Gamed the Electricity Market: An Empirical Analysis of Trader Knowledge*, *Journal of International Business and Economics* at p. 10 (forthcoming 2007) available at <http://www.trintrin.com/gebc/How%20Enron%20et%20al%20Gamed%20The%20Electricity%20Market%20An%20Empirical%20Analysis%20of%20Trader%20Knowledge.doc>