



# **Independent Power Producers of New York, Inc.**

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## **IPPNY's Comments on the RGGI's Phase II Allowance Auction Research Report**

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The Independent Power Producers of New York, Inc. (IPPNY) appreciates the opportunity to provide preliminary comments on the New York State Energy Research and Development Authority's (NYSERDA) revised commissioned report, entitled "Auction Design for Selling CO<sub>2</sub> Emission Allowances under the Regional Greenhouse Gas Initiative (RGGI): Final Report." IPPNY will provide additional and more refined comments on the allowance auction design, when we file our comments on NYSERDA's Draft Allowance Auction Rule.

IPPNY is a trade association representing the competitive power supply industry in New York State, including companies involved in the development of electric generating facilities, the generation, sale, and marketing of electric power, and the development of natural gas facilities. IPPNY's members generate almost 75 percent of New York's electricity using a wide variety of generating technologies and fuels, including hydro, nuclear, wind, coal, oil, natural gas, and biomass.

All of the views expressed in IPPNY's comments do not necessarily represent the positions of each of our members. Since IPPNY represents a broad spectrum of companies, we anticipate some of our members also will submit comments on their own. In addition, nothing in these comments should be deemed to waive any rights that IPPNY or any of its members may have to challenge the procedural or substantive legality of the RGGI rule or allowance auction or any element thereof.

IPPNY's comments address the following topic areas: (1) the auction format, (2) the frequency of the auction and the number of allowances to be sold, (3) concern about the auction reserve price and the treatment of unsold allowances, as well as the need to include an allowance auction price cap, (4) the viability of the secondary allowance market, (5) eligibility to participate in the auction and the appropriateness of providing generators the right-of-first refusal to allowance access, and (6) auction implementation and oversight.

Our comments contain, but are not limited to, the following recommendations:

- conduct a pilot auction, before implementing a live auction, and use the expertise of generators to ensure that the auction will work
- given that less than a full auction of allowances is being discussed nationally, phase-in the auction of RGGI allowances according to a schedule, such as: 25 percent auction for 2009 - 2011; 50 percent for 2012 - 2014; and 100 percent for 2015 and beyond
- ensure that the allowance auction-clearing price does not exceed a level that acceptably limits the impact of the allowance auction price on consumer rates and economic development. If the auctions begin to clear at too high a level, then impose an allowance auction price cap. If appropriate protections are available for consumer rates and economic development, then phase-down the price cap level over time, as more knowledge about the price of allowances in the secondary market

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becomes available. Also, if and when a commercially available and cost-effective CO<sub>2</sub> emission control technology is established, consider if eliminating the price cap is appropriate.

- provide generators the right-of-first refusal to access allowances, in order to ensure that generators can buy the allowances that they need to operate their facilities in a reliable manner, and allow others to obtain allowances in the secondary market
- if RGGI decision makers decide to include a reserve price into the auction design, despite the great uncertainty about how it should be established, set the allowance auction reserve price at an affordable level below the cost of compliance options
- roll unsold allowances that do not meet the reserve price into the next auction, instead of having the states bank unsold allowances
- perform additional analyses about the likelihood of a vibrant secondary allowance market in light of the auction of almost all RGGI allowances
- account for the findings of the 2008 NYISO's Reliability Needs Assessment (RNA), in deciding the appropriateness of the 33 percent limit on the amount of allowances a single bidder can buy
- include the New York State Reliability Council (NYSRC), in addition to the New York Independent System Operator (NYISO), in allowance market monitoring
- look at Maine's approach that would allow generators to receive a waiver or suspension of compliance with program requirements

## **1. Auction format**

The Allowance Auction Report recommends that the RGGI auction should use a uniform-price, single-round, sealed-bid format. The clearing price for the auction is the value of the highest rejected bid. The report notes that the uniform-price auction is familiar to the electricity sector, as it is the auction format used in most ISO electricity auctions. At the November 7<sup>th</sup> regional RGGI stakeholder meeting, Professor Shobe, a NYSERDA-commissioned auction design researcher from the University of Virginia, noted that this approach allows firms to bid aggressively without buyers' remorse, because they still can pay a lower uniform clearing price. He added that this provision is intended to ensure that those who need allowances will be able to get them. Professor Shobe indicated that the RGGI program would check to see if auction participants who value the allowances the most actually get to buy them in the auction. IPPNY concurs and believes that a sealed-bid auction is good, that a single-stage auction is a sufficiently simple approach, and that a uniform-price auction is beneficial.

RGGI states are in the process of deciding that almost all RGGI allowances will be allocated by auction, and the consequences of the auction process not working correctly are significant. As it will be too late to fix any problems with how the auction operates after it starts officially, IPPNY strongly suggests that the RGGI states conduct a pilot auction prior to the implementation of a live auction. The participants in this pilot auction must not be economics students but instead employees of electric generating companies whose daily function is to buy allowances in existing cap and trade program secondary markets. The auction designers and the sponsoring RGGI states should not waste an opportunity to get some "real world" input and experience from generators, who are in the best position to help "trouble-shoot" the auction model. Indeed, generators have assisted the NYS Department of Environmental Conservation (DEC) in testing and trouble-shooting other new software platform products, and their help in fine-tuning the RGGI auction should be no less useful than their contributions were in the past.

IPPNY agrees that a regional auction is preferable to a New York State-only auction. Once implemented, all states should use a regional auction approach, as RGGI is a regional program establishing a common carbon dioxide (CO<sub>2</sub>) allowance currency, and the auction and allowances should be consistent and identical instruments across the states. A single-state auction would be acceptable, but only until a regional auction is developed. IPPNY urges New York to participate in a centralized auction regime as soon as it is available in order to avoid the added administrative costs and other challenges for participants that would arise from multiple single state auction schedules. The auction platform should be open and transparent to encourage liquidity and provide credible price discovery to the market. The auction-clearing price should be revealed within 24 hours of its being established. The disclosure of the

number of allowances sold, as the report recommends, seems to be reasonable and useful information to market participants.

## **2. Auction Frequency and Number of Allowances to Be Sold**

The Allowance Auction Report recommends that auctions should be held quarterly and that separate auctions should be held for different vintages. The report recommends that future allowances should be made available four years in advance of their vintage. On each of the quarterly auction days, an auction would be held for current vintage-year allowances and an auction would be held for a future vintage. First-quarter auctions would include an auction of allowances from the one-year-ahead vintage, second-quarter auctions would include an auction for the two-year-ahead vintage, and so forth.

The Allowance Auction Report notes that generators want auctions of allowances of current and future vintages to occur before regional ISO capacity auctions to allow generators to be able to secure the allowances they need to perform future contract obligations. At the November 7<sup>th</sup> meeting, Professor Shobe said that quarterly auctions are intended to balance the need to set aside capital and the interest to maximize participation in the auction, with participants not having quite as much at stake in a given auction and not disrupting the secondary markets. He said that, in this way, generators can have access to allowances to cover their needs and allowances can come into the market on a steady schedule. Having future allowances available is intended to aid in compliance planning.

According to the report, a main auction design criteria is to align well with wholesale energy and capacity markets. The report recognizes that emission allowances are an input to the production of electricity and thus it is important that generators have an opportunity to purchase or contract for future purchase of emission allowances before they place offers to supply electric energy or generating capacity in the relevant markets. For some purposes, such as obtaining financing for new investment, the report notes that it may be important to obtain allowances that have a future vintage or that can be banked for the future to provide assurance to investors.

IPPNY is encouraged by the effort of the auction design team to establish an auction that takes into account the need of generators to be able to access allowances necessary to maintain the reliability of power plants. Allowances should be auctioned well in advance of the compliance true-up period to allow covered entities to assess compliance options and economic impacts. We agree that it is essential for the allowance auctions to be held in conjunction with the ISO / RTO auctions and to complement wholesale markets. Multiple auctions are beneficial, but monthly auctions would be better than quarterly ones.

According to the Allowance Auction Report, the auction design research team conducted experiments that included partial and no grandfathering (meaning to allocate allowances directly without an auction) of allowances, but the report's wording regarding the conclusion from these experiments is unclear. At the November 7<sup>th</sup> meeting, Professor Shobe explained that no significant difference was observed in the outcome of the auction research involving cases where allowances were auctioned or allocated directly; in terms of the price of allowances, the auction and the spot market tracked each other. IPPNY continues to urge RGGI decision makers to include a phase-in of the auction of RGGI allowances, given that such an approach is being discussed nationally. The following phase-in schedule was discussed by the DEC in a public meeting: 25 percent auction for 2009 - 2011; 50 percent for 2012 - 2014; and 100 percent for 2015 and beyond. Allowances in each auction should be apportioned to correspond to projected load levels forecasted for the auction period.

## **3. Reserve Price and Treatment of Unsold Allowances**

The Allowance Auction Report recommends that a reserve price should be used in each auction. The report indicates that, in general, the reserve price should be publicly announced, although in the first

an auction a reserve price may or may not be announced in advance. Regardless of how the reserve price is set, no bids for allowances would be accepted, if the bid price falls below the reserve price.

The report identifies two options for what to do with allowances that are not sold in an auction, because of insufficient demand or because the reserve price is not triggered. One option is that unsold allowances could be rolled into a contingency reserve account. The allowances in the contingency account would not be released for sale until some RGGI auction closes above a specified value, such as the first offset trigger price (\$7 per ton). Once this condition is met, the contingency reserve allowances would be available for auction on the next quarterly auction date. If the size of the contingency reserve account is limited and that limit is reached, then some unsold allowances could be rolled into the subsequent auction. Another option is that all of the unsold allowances could be rolled into the next auction.

IPPNY is very concerned about how the reserve price would be set for the first allowance auction. At the November 7<sup>th</sup> meeting, Professor Shobe indicated that the reserve price would be based upon recent market activity and that it would reflect the prices in the secondary allowance market. He said that there will be some forward trading of assets in anticipation of the market and that this information would be published. If not, the states would need to develop a strategy to make an estimate of what the reserve price should be.

IPPNY is concerned that the approach that Professor Shobe suggests will be based upon speculation in the market by players willing to take that risk, and it is a pretty big leap to include a reserve price in the first auction based upon such a far-reaching assumption. Indeed, a spot market will not be available to correspond with the timing of the first auction. The RGGI states are the ones who have the allowances, and they have not yet been sold. Also, no useful bilateral pre-auction market activity, other than possibly that engaged in by speculators, will exist, and allowances will not yet be available in the market for normal allowance trades. As a result, the basis for the reserve price that Professor Shobe suggests will not be apparent. Therefore, the auction designers and the RGGI states should not pretend that some useful proxy exists to set the reserve price.

At the November 7<sup>th</sup> meeting, Professor Shobe also indicated that allowances would not be sold below the value of carbon reduction, and allowances would not be sold below the reserve price. However, control technology is not commercially available to reduce CO<sub>2</sub> emissions at power plants in a cost-effective manner. As a result, the reserve price cannot reflect the value of CO<sub>2</sub> reduction. Until this technology is commercially available and cost effective, other options that generators may have for reducing or avoiding CO<sub>2</sub> emissions are not an appropriate benchmark for establishing a reserve price in the auction. The cost of implementing offset projects to reduce CO<sub>2</sub> is not widely known, and it remains to be seen how widely available investment opportunities in offset projects will be. Improving the efficiency of a power plant or switching to lower emitting fuels obviously are extremely costly undertakings and cannot conceivably be a basis for establishing a reserve price.

IPPNY is dismayed at how focused the allowance auction design team is on including a reserve price in the auction. Indeed, the reserve price was not a concept in the RGGI Model Rule. We are concerned that the reserve price will be set arbitrarily at a level that reduces the ability of generators to secure the allowances that they need to operate their facilities in a reliable manner. The auction designers cannot simply assume and rely upon generators being able to obtain allowances in the secondary market, since that market will include purchasers that have more market power than generators. If the chosen auction design results in generators not being able to acquire sufficient numbers of allowances, they would need to scale back or cease operations, thereby reducing fuel diversity and electric system reliability. Furthermore, we are concerned that the auction reserve price will drive up the price of allowances overall; as allowance prices go up, it is likely that the price of electricity also will rise and produce detrimental impacts on energy consumers.

If RGGI decision makers decide to include a reserve price, despite the great uncertainty about how it should be established, IPPNY asks that the reserve price be set low enough so that generators will be able to purchase the allowances that they need in a cost-effective manner to operate their facilities

reliably. In estimating a level for the reserve price, it is important to understand and remember the thought process of decisions in normal cap and trade programs. A generator generally evaluates the price of buying allowances against the availability and cost of installing emission control technologies and chooses the option that is most cost-effective. Given that emission control technology is not available for CO<sub>2</sub>, the reserve price must be set at an affordable level below the cost of compliance options, in order to ensure that generators will be able to secure the allowances they need. Otherwise, allowances cannot be purchased effectively in the auction, and the RGGI program risks becoming unsuccessful. Also, the allowance auction reserve price should be transparent and announced in advance.

Imposing a reserve price on the auction necessitates the inclusion of an allowance auction price cap. There will be a lack of symmetry in the design of an auction that includes a reserve price as a floor but does not include a cap on how high prices can go. Including an allowance auction price cap is important, especially if a phase-in of the auction does not occur. IPPNY underscores that the allowance auction design needs to provide price relief to address the limited ability of various generators to successfully obtain allowances, such as generators that will not be able to recover all of their allowance-related and other costs in the electricity market and generators that have long-term contracts that preclude such cost recovery. For example, as work on the RGGI-related rules proposed by individual states proceeds to ensure that these long-term contract holders receive some allowance allocation or cost pass-through without an "economic hardship" test, the allowance auction design effort needs to be sensitive to these issues and to include flexibility provisions that would ensure reasonable allowance prices in the allowance auction design.

RGGI decision makers should ensure that the allowance auction-clearing price does not exceed a level that acceptably limits the impact of the allowance auction price on consumer rates and economic development. If the auctions begin to clear at too high a level – which should be known relatively early in the process – then the allowance price cap should be imposed, before the initial "settling period" and the full additional twelve month period expires. If appropriate protections are available for consumer rates and economic development, then the price cap level could be phased-down over time, as more knowledge about the price of allowances in the secondary market becomes available. The price cap could be eliminated, if and when a commercially available and cost-effective CO<sub>2</sub> emission control technology is established. Under the allowance auction price cap approach, if the pool of allowances is not used up by the bidding parties, each bidder would receive the allowances they purchased. However, if the pool of allowances is oversubscribed, then the available pool of allowances should be prorated by the number of allowances for which each entity bid.

Allocation of allowances via auction with a price cap will not negatively impact the development of allowance prices in the secondary market. Under current successful cap and trade programs, allowances are allocated directly to generators at no cost, and allowance prices still are established in the secondary market that signal investment in emission control technologies. Similarly, the auction of allowances with a price cap as an allowance allocation methodology still will allow the secondary market to establish allowances prices that will lead to the development of CO<sub>2</sub> emission control technologies that can then be invested in and installed.

In regards to options for what to do with allowances that are not sold below a reserve price, a preferable approach would be to roll unsold allowances into the next auction, instead of having the states bank unsold allowances. IPPNY is very concerned about the amount of focus that auction designers have on placing unsold allowances into a contingency bank. We fear that not distributing all allowances will create a shortage leading to electric system reliability problems. The report's authors continue to optimistically assume that the offsets allowed under the RGGI program will result in price relief. The RGGI program and the NYS Draft RGGI Rule continue to restrict the use of allowances from offset projects to only 3.3 percent under normal circumstances and only up to 10 percent if regular allowance prices rise above certain levels. It is not clear if a RGGI offset market will develop and how many offsets will be available so it is inappropriate to further restrict the number of allowances available by withholding them in the contingency bank.

IPPNY disagrees with the appropriateness of using the contingency bank to minimize price volatility. Prices will already have become very high, if, as Professor Shobe suggests, allowances held in a contingency bank are released at the first offset trigger price (\$7 per ton) for sale in a subsequent auction. Indeed, before this tool would come into play, allowance prices will have risen well above the \$5 per ton level that the RGGI modeling optimistically predicted as the high end. In addition, the RGGI program participants will suffer from a lack of allowances to comply with the program until this tool becomes available. Banking unsold allowances would be an artificial tightening of the RGGI emissions cap resulting in an artificial impact on allowance prices. IPPNY underscores that the best ways to minimize price volatility and to ensure a reasonable program are to phase-in the allowance auction, include an allowance auction price cap, and allow unlimited use of offset allowances; these measures are essential until commercially available and cost-effective CO<sub>2</sub> emission control technology becomes available.

#### **4. Viability of Secondary Allowance Market**

According to the Allowance Auction Report, among the main auction design criteria are a liquid allowance market and no interference with the secondary market. The report states that “the auction should not impede the liquidity of the larger allowance market. Liquidity refers to the ability to convert emission allowances into cash through sale or to purchase additional allowances. Liquidity is not the same thing as the volume of trade in the allowance market. Liquidity is ensured by having many buyers and, in the secondary market, many sellers. The auction should not inhibit the smooth functioning of the secondary market by limiting options for trading ...”

IPPNY is concerned that the auction design process did not actually determine if there will be enough allowances available for a secondary market to form. We understand that the impact of the auction on the spot market was analyzed, but it is not clear that the market itself was modeled; additional analysis about the likelihood of a vibrant secondary allowance market after the auction of almost all RGGI allowances is necessary. The presumption of a liquid secondary market is based on allowances being available. However, in all previous cap and trade programs, the secondary market was made up of allowances that were deemed surplus by a source. That will not be the case in the 100 percent auction market. Compliance-affected source participants will not know whether they have excess allowances available to trade until well into the program. It is likely that compliance sources will target 90 percent of their expected emissions as their goal and will not reach that level until the end of 2010. The ultimate questions are who is going to sell allowances and will they have any incentive to sell their allowances for less than the price they paid in the auction.

#### **5. Eligibility to Participate in the Auction**

The Allowance Auction Report recommends the auctions should be open to all qualified bidders, which would include anyone willing and able to meet financial prequalification. According to the report, no single entity should be able to purchase (or take a beneficial interest in) more than 33 percent of the allowances for sale in any auction.

At the November 7<sup>th</sup> meeting, Professor Shobe noted that the U.S. Treasury limits one party to accessing 33 percent of the commodity units. He said that the number results from his reading about the U.S. Treasury note auction. In the Treasury notes auction, a broker tried to squeeze the treasury notes, got caught for the violation, and was punished. The limit is intended to reduce hoarding of allowances. He opined that a 33 percent block purchase would not happen under RGGI, because the program's allowance market is expected to be large with many bidders. He admitted that the 33 percent number was not explicitly modeled for use in the RGGI auction. IPPNY would like to point out that the Treasury market is very large and that close substitutes are available; this is not the case for RGGI, which is a very small market with essentially no substitutes. This difference must be kept in mind when deciding whether the 33 percent limit is appropriate or too large for the RGGI auction.

IPPNY urges RGGI decision makers and the DEC to take into account the findings of the 2008 NYISO's Reliability Needs Assessment (RNA), in deciding what amount of allowances a single bidder can buy. The NYISO's RNA estimates that the minimum number of allowances necessary to produce the required energy and capacity in 2010 is 52 million tons. Also, according to the 2007 RNA, the NYISO's RGGI scenario examined the retirement of most of the coal units in New York and determined that the loss-of-load-expectation (LOLE) criterion was violated, meaning that New York would be unable to meet applicable resource adequacy reliability requirements. In addition, a loss of a major nuclear unit would translate into a need for an additional 10 million tons per year of CO<sub>2</sub> allowances. The RNA finds that it is also possible that non-RGGI-affected entities could remove significant quantities of allowances from the New York markets for other purposes. The RNA notes that there are a finite number of allowances below which the RGGI-affected generators will become energy-limited resources. That is, without sufficient allowances, generators cannot operate to meet Bulk Power System electricity needs and also comply with the RGGI program. For these very reasons, the RNA indicates that the minimum acceptable number of allowances required for New York generators in the market place should be known, and the consequences of not having sufficient allowances should be well understood.

At the November 7<sup>th</sup> meeting, Professor Shobe commented that, if there is too much hoarding, RGGI can always decide to have auctions where only generators participate. IPPNY continues to argue for the need to provide generators the right-of-first refusal to access allowances in auctions generally, in order to ensure that generators have access to buying the allowances that they need in the auction to operate their facilities in a reliable manner. Non-generators can gain access to allowances through the secondary / spot market.

Under existing cap and trade programs, allowances are allocated directly to generators, and a broader group of allowance owners and purchasers participate in the secondary market. With this existing participation, current cap and trade programs are considered highly successful. Generators must be allowed to obtain written agreements from auction officials stating that they have first priority. These guarantees, which would be awarded on a first-come, first-served basis, would enable generators to assure lenders or investors that they have access to allowances needed to build and / or operate units.

Also, generators should be exempt from the surety requirements for auction participation. Requiring surety from generators adds an unnecessary cost burden, which also will contribute to electricity prices as generators seek to pass on those costs to consumers to the extent possible.

## **6. Auction Implementation and Oversight**

The Allowance Auction Report recommends that RGGI market monitoring efforts should take advantage of existing monitoring activities by federal and state agencies and other interested parties. The report indicates that RGGI should coordinate with the Federal Energy Regulatory Commission (FERC), the U.S. Environmental Protection Agency (EPA), the Independent System Operators (ISOs), and the Commodity Futures Trading Commission (CFTC) in designing criteria for detecting market manipulation and for sharing of information regarding the performance of the allowance market and the detection of attempts to manipulate prices. The report also recommends that the RGGI program should include an evaluation of the performance of the auction on an ongoing basis as part of the administrative oversight of the program.

IPPNY is encouraged that the ISOs would be involved in allowance market monitoring, but we strongly suggest that the NYSRC also be included. The NYISO, as part of its Comprehensive Reliability Planning Process, should coordinate its activities with the NYSRC and market participants and should monitor the auction results to avoid negative impacts on fuel diversity, competitive market outcomes, and reliability. A chief element of the NYISO's market monitoring approach would be stakeholder participation.

The Allowance Auction Report should be revised to provide more details on how market monitoring rules will work. The RGGI program should include a predetermined procedure that would be triggered to

address adverse impacts of the auction and secondary allowance market on energy consumers and electric system reliability. The procedure would be triggered at an allowance price level that would be below a level of allowance price escalation that is determined as resulting in unit retirements that would harm reliability and/or impacts on consumers that would be unacceptable and outweigh the benefit of further emission reductions. The RGGI program must define, in advance, this level of allowance prices that would trigger a program change designed to ameliorate unacceptable impacts on reliability and consumers.

The RGGI states and the DEC should look at Maine's approach that would allow generators to receive a waiver or suspension of compliance with program requirements, if not enough allowances are available to keep the electric system operating reliably and / or if the program would cause irreparable harm to a RGGI program participant. If at any time the NYSRC or the NYISO determines that the auction of allowances could have or is having negative impacts on fuel diversity and reliability, the auction must be stopped, and the remaining allowances must be allocated directly to generators at no cost. Also, the RGGI auction should be suspended, if public health and safety would be impaired or if the state runs out of allowances. The RGGI states, the DEC, and NYSERDA should work with the NYISO and the NYSRC on these issues.

Thank you for the opportunity to provide these initial comments.

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