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May 22, 2006

VIA E-MAIL

RGGI Staff Working Group
c/o RGGI List Serve
New York State Department of
Environmental Conservation
625 Broadway
Albany, New York 12233

Re: Initial Comments of Northeast Suppliers

Ladies and Gentlemen:

In accordance with the requirements set forth on the RGGI web site, enclosed are the Initial Comments of AES Eastern Energy, LP, NRG Energy, Inc., Dynegy Power Corporation and US Power Generating Company, LLC ("Northeast Suppliers") on the March 23, 2006 Draft Regional Greenhouse Gas Initiative Model Rule issued by the Inter-State RGGI Staff Working Group. The Northeast Suppliers own and operate approximately 15,000 MWs of generating resources in the RGGI region.

If you have any questions, please call or e-mail me.

Very truly yours,

GREENBERG TRAURIG, LLP

Doreen U. Saia

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INITIAL COMMENTS OF AES EASTERN ENERGY, L.P., NRG ENERGY, INC., DYNEGY POWER CORPORATION AND US POWER GENERATING COMPANY, LLC ON THE MARCH 23, 2006 RGGI DRAFT MODEL RULE

I. EXECUTIVE SUMMARY

AES Eastern Energy, LP, NRG Energy, Inc., Dynegy Power Corporation and US Power Generating Company, LLC (collectively, "Northeast Suppliers") appreciate the opportunity to comment on the Draft Model Rule for the Regional Greenhouse Gas Initiative ("RGGI"), which the Inter-State RGGI Staff Working Group provided for public comment on March 23, 2006. The Northeast Suppliers, taken together, own and operate approximately 15,000 MWs of generating resources that are located throughout the RGGI region.

As the Draft Model Rule is reviewed and this effort continues, the focus must remain on the primary goal of the RGGI program – securing carbon dioxide emissions reductions while maintaining energy affordability, fuel diversity and system reliability. The independent system operators in the three Northeast regions with States engaged in the RGGI effort -- New England, New York and PJM -- all have issued planning studies establishing that additional generating resources must be added to each of their respective systems by 2008.[1] Given these identified capacity needs, this effort must not proceed in a vacuum.

Rather, it is critical that impacts on energy affordability, existing fuel diversity, electric system reliability and the ability to attract investment capital for new infrastructure remain key considerations as the Model Rule is completed. A final Model Rule that results in substantial cost disadvantages for in-region generation will result in several unintended negative consequences, including: (i) an artificial and otherwise unwarranted competitive advantage for higher emitting generation from non-participating States both inside and outside the RGGI region which directly will lead to increased environmental leakage into the RGGI States; and (ii) greater difficulty in obtaining investment for new facilities and for upgrades to needed existing facilities in the RGGI region at the very time when such infrastructure will be needed.

As an initial matter, the Northeast Suppliers strongly believe that two steps must be taken before any Model Rule in final form can be issued. First, several critical issues remain outstanding that must still be analyzed and addressed by the RGGI policy makers and the stakeholders that have been engaged in this initiative. For example, as discussed more fully herein, a working group has been developed to consider the potential environmental leakage issues that may result if the Draft Model Rule is not developed properly. This group must be permitted to complete its review of the potential leakage problems within the RGGI region and at the borders. Likewise, as has long been requested,[2] comprehensive reliability studies also must be conducted either jointly by the independent system operators or under their direction. These studies are critical to understand the potential reliability impacts of this initiative on the Northeast energy grid.

Second, many proposed aspects of the Draft Model Rule must be developed in far more detail before any assessment can be made as to whether the Draft Model Rule is feasible. For example, if the Draft Model Rule ultimately allows a participating State to contemplate using

[1] See "Northeastern Coordinated System Plan: 2005. A Status Report of the Northeastern ISO/RTO Planning Coordination Protocol" (dated April 6, 2005).

an auction, the parameters for the auction, such as the frequency of auctions and the structure of the auction itself, must be prescribed. In addition, if some level of set aside for public benefit programs or other programs is ultimately proposed, rules also must be developed for the release of such allowances back into the market. In the absence of doing so, hoarding and gaming issues may result, thereby artificially driving up allowance costs, and correspondingly, electricity prices with the potential for a major impact on reliability.

Due to the large number of open issues that remain at this time, the Northeast Suppliers reserve their right to raise additional issues as more information and details become available.[3] The Northeast Suppliers further reserve all rights to challenge the legal authority underlying any respective RGGI State's subsequent legislative or administrative promulgation of rules derived from any final Model Rule.

With this in mind, several points warrant comment based upon the limited information that is available at this time:

- **Allowance Allocation**. The regional allowance pool should not be stripped by 25% and transferred to a public benefits auction or other set aside. Requiring generators to purchase a significant number of allowances will have significant negative consequences for generators that are needed to maintain fuel diversity and system reliability. To the extent that the Model Rule ultimately includes any level of set aside, it must be limited to no more than 25% of each State's overall allocation.

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[2] See, e.g., New York State Reliability Council Initial Comments, dated April 22, 2005; see also Letter from New York State Reliability Council to NYPSC Chairman William M. Flynn, DEC Commissioner Denise M. Sheehan and NYSERDA President Peter R. Smith, dated October 7, 2005.

[3] The Northeast Suppliers believe that another Draft Model Rule should be issued for further comment once these two steps have been taken.

- **Offsets**. The overall amount of offsets that a generating unit is able to use to comply with this program should not be limited. Moreover, there is no basis to artificially superimpose any geographical constraints on the source or use of offsets. Lastly, because they further the goal of reducing the overall level of greenhouse gas emissions, the development of offset projects must be fostered and there must be a streamlined and transparent certification process for such projects to be approved. In light of the significant and valuable work completed by the European Union in this area, it is not necessary to begin from "Square One." Rather, the RGGI States should utilize this information to expeditiously designate additional approved offset projects for this initiative. The stated goals of the RGGI program will otherwise be compromised by arbitrary limitations placed on the creation and use of offsets.

- **Leakage**. The desired environmental benefits of the RGGI program are likely to be diminished by increased emissions from sources outside the RGGI region and sources in States within the RGGI region that are not participating in the RGGI initiative. This effect may occur through generation shifts to lower cost and higher emitting generation that is not affected by the RGGI program. The extent and effects of such leakage must be fully evaluated before a Model Rule can be adopted.

- **New Facilities**. The NYISO, ISO New England and PJM each project the need for their respective control areas to add generating capacity and increase fuel diversity in order to avoid reliability risks in the 2006 to 2008 time frame. The Model Rule must more effectively account for, and address, new and repowered facilities.

- **Further Analysis**. Before moving forward with the Model Rule, further modeling and analysis must be performed based on the revised RGGI region footprint of States that have affirmatively elected to participate in this initiative and updated assumptions to more accurately reflect current conditions. In addition, the impact of RGGI standards. in conjunction with other federal and State specific environmental initiatives, on fuel diversity and system reliability also must be fully analyzed.

- **Predefined Emissions Reduction**. Any mandatory reduction assigned to some point in the future is premature. Auction approaches are largely untested. Indeed, if the 25% allowance allocation provision that is currently set forth in the Draft Model Rule ultimately is adopted, no auction of nearly this proportion has ever been tried. Moreover, unlike other targeted emissions such as NO_x and SO_2, the RGGI effort is further complicated by the fact that no control technology currently exists to control carbon dioxide emissions. As a result, defined emissions reductions for a date certain in the future cannot be prescribed until the actual impacts of this program are fully identified, analyzed and quantified.

II. COMMENTS

A. Allowances Should Be Allocated to Affected Generators

To contain the effects of this initiative on electricity clearing prices to the degree possible, the Northeast Suppliers advocate that all allowances be directly allocated to affected sources. Analyses in support of awarding set asides to consumers and public policy programs through an auction methodology have been limited and have failed to accurately account for the market design of the deregulated marketplace or operational limitations that are faced by generating facilities. While these flaws were identified early in the process,[4] including the limited analysis of capital market financing requirements and infrastructure limitations, they were never addressed. Due to the potentially drastic negative consequences that an auction approach may have on facilities that are needed for fuel diversity and system reliability, allowances must be allocated to the affected sources.

However, to the extent the Model Rule ultimately contains a set aside for distribution for a consumer benefit program or other public purpose program via an auction process, the withheld amount should be a small percentage, perhaps 5 to 10%, and in no event greater than the 25% currently proposed by the Draft Model Rule. (See Draft Model Rule xx-5.3(a).) Although the Model Rule is silent on how these allowances will be administered, it appears likely an auction will be used. As noted above, it is unclear how much of the set aside will be available for use by generators. Moreover, the fact that there has been virtually no experience with an auction approach raises a second level of concern.

If there will be an auction process, the Model Rule must prescribe procedures for the allowance auction that are practical, efficient and fairly administered. The Model Rule should specify how long the State may be allowed to hold the allowances. In addition, the State should not permit speculators and other third parties to participate in the auction until the allowance requirements of generators are satisfied. Lastly, allowances should be made available to affected generators prior to the first compliance period, so that market liquidity is not adversely affected and companies have adequate time to plan least cost compliance strategies.

[4] See, e.g., Mark D. Younger, "An Assessment of the Public Benefit Set Aside Concept Taking Into Account the Functioning of the Northeast/Mid-Atlantic Electricity Markets" (dated October 11, 2004); see also Mark D. Younger, "CO2 Allowance Allocation in Regional Greenhouse Gas Initiative" (presented to October 14, 2004 RGGI Workshop meeting).

Moreover, due to potentially significant reliability and fuel diversity implications, any auction process should be subject to review by the New York State Reliability Council, the Northeast Power Coordinating Council, the NYISO, ISO-NE and PJM. These entities must certify that the auction structure that ultimately is adopted will not have negative impacts on fuel diversity and reliability. Thereafter, these entities must be charged with continuously monitoring the impacts of the auction on fuel diversity and reliability.

B. Use of Offsets Should Not Be Restricted

Offsets are a key component of any greenhouse gas program, particularly given the fact that there are currently no equipment alternatives to control such emissions.[5] There is no logical or environmental reason to restrict either the location or the type of offsets. (See MOU § 2F; Draft Model Rule xx-6.5, xx-10.3(a)(3).) Greenhouse gases are a global issue. It is appropriate for both environmental and economic reasons for the Model Rule to allow offsets from international Clean Development Mechanism projects, the European Union program, and across the entire United States.

In fact, limiting offsets in any way flies in the face of the stated goal of the RGGI program to reduce greenhouse gas emissions while maintaining energy affordability and reliability. Specifically, any restriction on offsets will artificially diminish the amount of reductions in emissions that otherwise could have been gained had offsets been freely allowed. Moreover, restrictions on offsets will reduce compliance options for generators, thereby artificially and unnecessarily driving up compliance costs for the RGGI region as a whole.

In order to develop a robust offset market that promotes the eligibility and availability of offsets, offset rules should be reasonable, transparent, simple and flexible. The

[5] The Northeast Suppliers concur with IPPNY's analysis concerning the need to liberally apply offset programs.

Model Rule should maximize options for reducing emissions and encourage investments from multiple sources to ensure that viable offset projects and emission reductions are brought to realization as quickly as possible. Any category of offset project that is real and verifiable should be included in the RGGI program. Moreover, once an offset project has been certified, it must be permitted to maintain its certification on the same terms for at least 10 years. In the absence of such provisions, it will be exceedingly difficult, if not impossible, to attain the needed financing for such projects.

In addition, the Model Rule should allow for more offsets to be added without the need for a change to the regulations. The Model Rule should incorporate a transparent, time-sensitive and verifiable review process for the approval of such new offset programs.

Lastly, unrestricted offsets would allow RGGI region companies to have access to a wide array of more cost efficient offsets both within and outside of the RGGI region, while ensuring real, verifiable and quantifiable emission reductions. This would help to partially neutralize the economic disadvantages that the RGGI program may otherwise create.

C. Leakage Issues Must Be Analyzed and Addressed

Electricity prices in the RGGI region are higher than in the contiguous area, while CO_2, SO_2, NO_x and Hg emission rates resulting from electricity production overall are lower. Additionally, the region is a net power importer. Unquestionably, the imposition of greenhouse gas emissions limits in the region will exacerbate this situation, making generation within the region even more expensive relative to generation outside the region. Thus, it is likely that any reductions in emissions within the region will be substantially offset by an increase in imported power with its associated higher emission levels. This result is obviously contrary to RGGI's goals.

The RGGI Memorandum of Understanding ("MOU") provides for the establishment of a multi-State Imports and Leakage Working Group to assess the leakage issues and consider potential options for addressing leakage problems. (See MOU § 6A.) This Working Group is scheduled to issue its findings and conclusions by December, 2007. (Id. at § 6A(1)(b).) To do so, the Working Group must first undertake sufficient modeling to understand more fully the potential for leakage and the opportunities for addressing the problem.

In conducting this analysis, the Working Group must look at NO_x, SO_2 and Hg emissions as well as CO_2 emissions to understand the full impacts of this initiative. It also must analyze the likely impacts associated with AEP's transmission line from the coal country corridor to New Jersey. Moreover, with the decisions of Massachusetts and Rhode Island not to participate in the RGGI initiative, leakage issues caused by sources both internal and external to the RGGI region must be fully analyzed and addressed.[6]

The Working Group must have the opportunity to complete its analysis. Once completed, stakeholders must have the opportunity to evaluate and comment on the Working Group's final report. Only then can the participating States have sufficient information to be in a position to issue the Model Rule in final form.

D. New and Repowered Units Should Be Exempt From the RGGI Program

As previously noted, the three independent system operators across the Northeast have each identified the need to add capacity in its respective control area to maintain fuel diversity and meet load. The Northeast Suppliers believe that energy conservation and renewable facilities should play an important role to address these needs but, taken alone, they

[6] With two of the New England States carved out of the RGGI initiative, but otherwise geographically located in the center of such region, these analyses will be further complicated by the fact that leakage effects must be measured from resources that are outside and within the RGGI region.

will not be sufficient to address the gap between supply and load. Unless such new capacity is only comprised of nuclear facilities -- which also is not likely, the addition of new facilities will result in increased emissions in relation to the current size of the cap proposed for each State. Thus, the Model Rule should contain specific standard provisions for new and repowered units that allow the units to be built without affecting the ability of needed existing units to operate under the cap.

A 3-5% new source set aside, which has become routine in cap and trade programs, will not provide adequate allowances for new entrants in the RGGI region. However, establishing a higher set aside would likely result in insufficient allowances for existing units, thus endangering system reliability. Accordingly, in light of the significant need for the construction of new capacity, new and repowered units should be exempt from the RGGI program requirements.

E. Further Modeling and Analysis Is Necessary

The Model Rule cannot be adopted until the current modeling results have been updated to reflect the significant changes that have occurred. Specifically, the only modeling available as of this time assumes that Rhode Island and Massachusetts would be Member States, and that Maryland would not. Such modeling also fails to take into account New York Governor George E. Pataki's recently announced Advanced Clean Coal Power Plant Initiative ("Pataki Clean Coal Initiative"). In addition, rising international oil demand and national natural gas demand have given rise to significantly higher fuel prices. Thus, at a minimum, modeling must be updated to account for the change in RGGI Member States, the construction of new facilities under the Pataki Clean Coal Initiative and increased current and foreseeable fuel prices.

In addition, the RGGI States have yet to conduct any analysis of the potential impacts that the Draft Model Rule may have on the reliability of the electric system and the fuel diversity upon which such reliability is based.[7] At a minimum, a reliability analysis must include:

- A realistic assessment of the retirement of generation units that will result from the Draft Model Rule and the related impacts on fuel diversity and concomitantly reliability, as well as the impact of the retirement of one or more nuclear units;
- In light of the modeling assumptions that all new generation will be renewable based or natural gas fired, a realistic assessment of the gas infrastructure enhancements that will be needed to meet the projected demand for natural gas based on the Draft Model Rule;
- A realistic assessment of the ability of the bulk power system to accommodate the projected level of imports based on the Draft Model Rule; and

Based upon a complete analysis of the foregoing, the Model Rule should be modified to the extent necessary to ensure that the reliability of the Northeast bulk power system is maintained. Completion of this analysis must precede State agency sign-on to the Model Rule in order to identify and adequately resolve any reliability issues.

In addition, RGGI staff must analyze the Draft Model Rule in the context of all other federal and State-specific environmental initiatives to ensure that these rules, taken together, can work well and will not result in adverse fuel diversity or reliability consequences. RGGI State energy and environmental regulators should work more closely with each other to consider the cumulative impact of these regulations on the ability of the energy system to continue operating in a reliable manner.

F. 10% Reduction Between 2015 and 2018

[7] In its 2005 Reliability Needs Assessment, the NYISO established that fuel diversity is important from a reliability perspective as well as an economic perspective. (See NYISO 2005 RNA at 20.) The NYISO then recognized that a host of new federal and State-specific environmental initiatives that would apply to generating facilities, including this initiative, could have a significant future impact on resource availability and, thus, the reliability of the interconnected system. (Id. at 45.)

The MOU includes a mandatory predefined 10% cut in emissions to be applied between 2015 and 2018. (See MOU § 2D.) The MOU further calls for a comprehensive review to be conducted in 2012. (See MOU § 6D.) Mandating a specific emissions cut before the analysis of the program is completed renders such analysis meaningless. Indeed, any reduction goal at all is premature until the actual impacts of this program are fully identified, analyzed and quantified, including whether leakage impacts have negated any stated environmental benefits, or even worse, have led to overall higher emissions in the region. Thus, no predefined emissions reductions applied to a date certain in the future should be included in the Model Rule.

III. CONCLUSION

Until the current modeling has been updated to reflect the significant changes in assumptions, until reliability studies are completed and until the Leakage Working Group has completed its analyses, the RGGI States will not have sufficient information to issue a Model Rule. Moreover, more details concerning several aspects of the Draft Model Rule must be provided before stakeholders, including the Northeast Suppliers, can be in a position to assess its feasibility.

In light of the information available as of this time, the Northeast Suppliers urge the RGGI States to modify the Draft Model Rule in the following material respects: (i) eliminate the set aside entirely or, if ultimately adopted, specify that it must not exceed 25% in any State; (ii) eliminate all restrictions on the type, amount and geographic location of offsets; and (iii) expressly exempt new and repowered facilities from this program.

Dated: Albany, New York
May 22, 2006

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