CONSERVATION LAW FOUNDATION

May 22, 2006

To: RGGI Environmental Regulatory, Energy Policy and Utility Regulatory Commissioners,
RGGI Staff Working Group, and
RGGI Stakeholders

From: Seth Kaplan, Director, Clean Energy and Climate Change Program

RE: Comments on the RGGI Model Rule Draft

The Conservation Law Foundation (CLF) is pleased to offer the following comments on the RGGI model rule. These comments are not exhaustive – we are well aware and grateful for the additional comments of our fellow stakeholders. The purpose of these comments is to expand upon the comments made at the recent Stakeholder meeting in Hartford – focusing on the critical questions of the underlying integrity of the program and the potential for eligibility issues, "leakage" and questionable offsets to undermine that integrity.

We strongly believe that the essential context for considering and revising the Model Rule must be an honest recognition of the strengths and weaknesses of the RGGI effort and the MOU that is now its defining document.

In the simplest and most direct terms this means that we can not lose sight of the fact that the essential purpose of RGGI is to reduce greenhouse gas emissions from one key sector in one region in the United States. The program is also a vanguard effort that will lead the way towards needed reductions from other sectors and other regions of the nation and world is important; but it can only serve that function if it makes real and credible reductions in the targeted sector. This set of facts pushes for minimization of the use of offsets in the RGGI program ensuring that the reductions actually happen in the regulated sector. Given the leading role that the electricity sector will have to play in the quest for emissions reductions, described in the New England Governors / Eastern Canadian Premiers Climate Action Plan and many other similar analyses, it is essential that this clear signal be sent to the electricity sector.

The second essential fact is that the RGGI effort mandates only modest, achievable and (if done even remotely correctly) inexpensive reductions from the regulated sector. If it were a more ambitious program the case could be made that compliance mechanisms that reach more broadly into other sectors and geographic areas are desirable – however given the nature of the program not only are such extensions not desirable but may in fact be unworkable. The lesson we seem to be learning from the initial experience of the European carbon market is that a market that launches with overly high initial caps and oversupply of tradable credits is inherently unstable. Given the level of the initial caps and the potential to bring into the system substantial number of

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offsets the states engaged in the RGGI process may very well be in danger of replicating that mistake.

The third defining fact is the potential vulnerability of the program to being undermined by increases in emissions attributable to increased imports of electricity from outside the region, a phenomena generally referred to as “leakage.” Preventing such leakage is a critical need if the program is going to deliver the emissions reductions that are the very purpose and heart of the program.

These challenges suggest some specific steps that should be taken by the states that will require revisiting the MOU, for example, reducing reliance on offsets in the program by reducing below 3.3% the amount of source budgets that can be met through offsets and eliminating the “Stage One Trigger” that widens the pool of offsets when allowance prices reach $7 a ton. Additionally, the ill-defined and vague category of “strategic energy purposes” as a legitimate use for revenue from the sale of the allowances should be seriously rethought as it may result, in the implementation in some states, in improper use of that revenue flowing back to generators, undermining the entire concept of an allocation sale mechanism. **The focus of allowance sale programs must be on the inextricably intertwined goals of lowering the cost of the program, assisting in the reduction of emissions and returning the value of the allowances to ratepayers.** Nothing achieves this goal better than investing the allowance sale revenues in energy efficiency efforts.

Our focus here, however, is on responses to these issues that can be addressed in the process of revising the Model Rule and these are set forth below in detail.

The Model Rule must address leakage in the Model Rule by acknowledging and setting in motion the coordination between the environmental regulatory agencies that will be adopting the Model Rule and the utility regulators that will be vital in addressing this issue. This coordination must, at the very least, take two forms – assisting the utility regulatory commission in formulating a parallel model rule and in implementing such a utility commission model rule by sharing compliance data and analysis with the commission as the implementation unfolds. Specifically, we urge the following revisions to the Model Rule:

- Clearly state in the Model Rule, as the MOU does, that the “potential that the Program may lead to increased electricity imports and associated emissions leakage” and acknowledge the clear and immediate need for a utility commission model rule that addresses this question in an effective manner that is designed to be consistent with state regulatory law and federal constitutional principles. This section should note that “UTILITY COMMISSION” of the adopting state will need to take a major role in addressing this issue.

- State in the body of the Model Rule that, “the REGULATORY AGENCY will provide periodic reports to the UTILITY COMMISSION on the implementation of this program and provide the staff of the UTILITY COMMISSION with access to all compliance data and analysis which the UTILITY COMMISSION and their staff need to implement complementary rules and processes for implementing this program.”

The Model Rule must maintain the integrity of the cap by not eliminating the de-facto exclusion of units that are powered with substantial amounts of biomass and that sell less than 10% of their output to the grid. Revisions to Section XX-1.4 should be made to clarify that any fossil fuel use by a unit, other than a defined de minimus amount, will result in that unit being fully subject to the program. Similarly, any unit that sells more than a de minimus amount of electricity "to the grid" should be fully subject to the program – in this case regular commercial sale of as much as 10% of the output from a large generating unit can not be described as de minimus, in such a case the sale of electricity is a regular, if ancillary, part of the business of the unit.

The Model Rule must maintain the integrity of the cap by clarifying that early reduction credits must come from within the emissions cap that is the core of the program, avoiding the unfortunate additional inflation of the cap that will flow from the current language in the Model Rule. This problem can be easily remedied by adding to the end of Section XX-5.3(c) a sentence stating that, "Such ERAs shall be drawn from the account established by Section XX-5.3(a)." Failing to fix this problem and allowing early reduction credits to be stacked on top of the cap undermines the negotiated budgets and regional cap that is the very heart of the program.

The Offsets provisions of the Model Rule must explicitly reference the eligibility criteria stated in the MOU and use that language as a (1) a benchmark for evaluating whether the specific offset provisions in the Model Rule are truly meeting their goal and (2) as a metric for evaluating and analyzing proposed additional offset categories. As an initial matter, adding the following underlined language to Section XX-10.3(a) would be a critical step forward:

> The REGULATORY AGENCY may award CO2 emissions offset allowances <u>that represent and account for CO2 emissions reductions that are real, surplus, verifiable, permanent and enforceable</u> to the sponsor of any of the following types of CO2 emissions offset projects that have satisfied all the applicable requirements of this Subpart.

A new section, probably denominated as Section XX-10(3)(i) will be needed that clearly establishes that the there will be:

> "periodic review (at least annually) of the standards set forth below in order to determine if the offsets being awarded pursuant to this Subpart are truly real, surplus, verifiable, permanent and enforceable. During such review the REGULATORY AGENCY will consider any proposed additional offset categories and analyze whether offsets awarded pursuant to proposed regulations defining such categories will be real, surplus, verifiable, permanent and enforceable."

If this core offsets eligibility language from the MOU is not imported into the Model Rule there is a substantial risk that future agency staff will not understand the fundamental nature of this requirement.

A sober reanalysis is needed of the offset categories set forth in Section XX-10.5 to determine if these categorical requirements are truly going beyond "best practices" and are truly surplus and additional and to ask if the steps needed to meet this standard render such a category unusable to a large degree whether such a category should be included in the Model Rule.

The States have already made the sensible determination that the "reduction in emissions from natural gas transmission and distribution equipment" category contemplated by the MOU is not currently workable - this same determination should be made for at least two of the other offsets category.

The complexity of the provisions regarding SF6 offsets and end use energy efficiency and the fact that these sections of the Model Rule can be accurately read as a good compilation of "best practices" for addressing these sectors (which can, should and is being done for a wide variety of reasons) suggests that these categories enumerated in Sections XX-10.5(b) & (d) should not be included in the final Model Rule.

That is not to say that end use efficiency does not have a critical role to play in achieving the reductions that are the goal of this program but we believe that the appropriate tool for that job is the financial incentives and programs that can be funded through the sale of allowances – not through this offsets category.

These comments end where they began, noting that the implementation of RGGI through the Model Rule must clearly recognize the very mild nature of the reductions contemplated in the program and show courage in not doing anything that further weakens the program. Creating intricate schemes that will be very difficult for many states to implement for rewarding SF6 reductions and awarding offsets credit for good practices that should be undertaken by all owners and operators of buildings is not consistent with this principle.

As with all regulatory programs there is an implicit bargain at the heart of the effort. Ratepayers are being told that regulation of the industry that they rely upon is needed in order to achieve an important societal goal – in this case the inarguably important goal of reducing greenhouse gas emissions. In order to keep faith with them the program must not only be executing as efficiently and in a "least-cost" manner but it must be truly effective in meeting its goal.

We firmly believe that the RGGI effort represents an important step in the right direction in addressing the fundamental question of greenhouse gas emissions from a key sector of our society remain grateful for the opportunity to participate in moving RGGI forward.