IETA
INTERNATIONAL EMISSIONS TRADING ASSOCIATION

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Dear Mr. Litz:

In response to the March 23 request for comments on the draft Model Rule, the International Emissions Trading Association (IETA) is providing its comments in the form of this letter. These comments have been prepared by IETA's US Working Group. IETA's membership of over 110 companies is a diverse mix of all segments of the greenhouse gas (GHG) market including many large energy and industrial companies as well as the financial and banking sector, legal firms, brokers, traders, consultants, industry associations, policy institutions, verifiers and certifiers.

The role of IETA is to provide input on design issues related to greenhouse gas emissions trading by advocating flexibility, openness, and encouraging optimum liquidity. IETA does not participate in the scientific debate over climate change or advocate legislation for mandatory caps and timetables. IETA's goal is to facilitate the establishment of efficient liquid emissions trading markets that will help participants to achieve compliance with regulatory regimes in the most cost effective manner.

As such, IETA's goal is to facilitate the establishment of efficient liquid emissions trading markets that will help participants to achieve compliance in the most cost effective manner. To this end, we believe that any market system that is developed in the U.S. should include the following basic principles: verifiable, credible data, transparency, simplicity, low transaction costs, high liquidity, and fungibility with other systems and mechanisms. In this regard, we have the following comments on the Model Rule.

General Comments

IETA has previously expressed its reservations over the narrow scope of the RGGI program. The creation of an emissions trading scheme in a specific sector within a limited geographic area must necessarily locate the majority of the emissions reductions within the same field. This will preclude the effective operation of the market to discover the lowest possible social costs of greenhouse gas reduction.

While IETA recognizes that many of these decisions of scope are now firmly embedded in the RGGI structure, we are compelled to reiterate our concerns. Further, IETA believes that this fundamental logic sets a standard by which the Model Rule should be tested: are decisions being taken at the inception of RGGI that in any way compromise the expansion of the trading structure either sectorally or geographically? As much as possible, the development of the RGGI structure

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should be done with a clear eye toward the implications of setting precedent. IETA would urge the RGGI Staff Working Group to make decisions of architecture to adhere to the RGGI Memorandum of Understanding while keeping open the possibility of desirable changes.

It is difficult to provide final and definitive comment on the Model Rule without consideration of the overall framework as it pertains to the issues of imports and leakage. IETA's comments to elements of the Model Rule may materially change depending on the management of these issues within RGGI.

Allocation

IETA believes strongly that any proposed cap and trade program should not include any significant auctions (or set-aside of allowances for public benefit purposes) as a mechanism. Auctions will increase company and customer costs/risks substantially and have the potential to distort the trading markets. Where auctions are included, IETA would urge that they only be for minor amounts (i.e. 5-10% or less) of the total allowance allocation, mainly for two reasons.

First, auctions will result in a major redistribution of funds through a new government bureaucracy, reducing market efficiency and reducing funds available for companies that need to make investments in emerging technology to make future CO2 reductions. Investment in compliance technologies will effectively be competing with the substantial investment needed to buy auctioned allowances. The stress on available capital between competing interests could actually delay equipment capital decisions that would have reduced CO2 emissions.

Second, in the Northeast deregulated electricity marketplace (RGGI region), the electricity market clearing price is generally set by natural gas or fuel oil generation.. Accordingly, the market clearing price only compensates generation based on the CO2 content of gas, which is about half that of coal. Accordingly, the market clearing price does not cover total CO2 compliance costs from coal fired sources in particular. Auctioning allowances only increases the costs that must be borne by these sources (without any environmental benefit).. The modeling indicates oil fired units will run at even lower capacity factors, requiring some form of reliability contract, outside the current market mechanism, to remain viable. This is problematic for many oil-only facilities that do not have the capability or access to natural gas.

In a marketplace that already has identified natural gas infrastructure concerns and already has some of the highest electricity rates in the US due in part to reliance on natural gas as a major fuel source , further erosion of other available fuel diverse generation options is especially problematic. Also, additional reliance on natural gas could result in operating, reliability, capital market, and energy market problems. A balanced handling of the allocation issue is necessary to avoid these unintended outcomes.

IETA does not see the windfall profit comparison to events in both the European and UK power markets as relevant to RGGI. While the CO2 program may increase the profitability of nuclear, hydro and other non-fossil units, it will not do so for coal and oil units. Thus, an auction of allowances will not serve to redistribute higher profits since auctioned allowances will come largely from coal units which will see profits reduced. Rather, we see a significant fuel diversity problem if the allocation issue is not managed correctly. Further, the scope for windfall profits is significantly limited by the likelihood that electricity will be imported from outside the RGGI

States and that RTOs such as New England or PJM contain a number of states that are unaffected by RGGI. As such, the auction mechanism will place a double burden on RGGI state energy producers already required to make investments in CO2 reductions..

The use of the auction mechanism to distribute not less than 25%, and possibly significantly more, of the emissions allowances runs the risk of imposing a significant economic burden on affected interests where this is simply not necessary. In parallel with the business-as-usual targets in the first years of operation, the national precedent that RGGI risks setting is that taking any action faces economically prohibitive costs, risk creating real problems in fuel diversity out of all proportion to the reductions achieved

As such, the use of the auction mechanism to create set-aside allowances for public benefit is an unnecessary complication.

Instead, IETA recommends that any allocation of allowances should be done through benchmarking or grandfathering, rather than auctioning and redistribution. This will mitigate customer impacts far better than a government redistributive program. IETA recognizes that the Memorandum of Understanding has determined the minimum use of the auction mechanism, and without prejudice to the preceding concerns, advocates the highest degree of consistency and transparency in the use of the auction mechanism in the widest possible market.

Where auctions are used as a significant allocation mechanism, we must stress the importance of regional consistency across all RGGI member states, in terms of both percentages and rules. There is otherwise the potential for significant distortion in the market. IETA would urge the RGGI Model Rule workgroup to include as much guidance on the structuring of auctions as possible within the scope of the Rule.

Offsets

IETA must applaud the decision to embed a basic international compatibility through the recognition of the UNFCCC standards through the permanent retirement of Certified Emissions Reductions credits. However, in other regards, the RGGI framework does not provide encouragement for potential suppliers to the offset market in the United States. The 3.3% limit on the usage of offsets purchased outside the electrical sector dramatically limits the size of the potential offset market, to such an extent that it is unlikely that the RGGI market will engage the interest of offsets investors. This is compounded by the de facto requirement that all offsets originate in the RGGI states.

IETA does not believe that the supply of offsets or other credits derived from effective compliance measures should in any way be capped. This runs contrary to the fundamental logic of emissions trading. Reductions of emissions should produce additional credits fully tradable within the market. The market should be allowed to discover the lowest cost opportunities for abatement, allowing the price signal to drive the task, not government intervention. To date, there has been no environmental or economically supportable reason provided to restrict either the use or geographical location of an offset project. In fact, the limitations in place will increase cost and result in less desirable environmental performance.

Renewable Portfolio Standards & Energy Credits

The effect of the transfer clause in XX-10.3.d.ii is to split the renewable energy market, and introduce an unusual separation of the REC's resulting from investment in such projects. The market standard to date has been to allocate RECs as part of the return on investment. It is not clear that the revenue that would result to the regulatory agency merits the potential deterrent effect on the use of renewable energy technologies. It would be preferable to align the RGGI structure with existing incentives to further encourage the growth of the renewable energy market. Conversely, the proposed structure would fragment a nascent market.

Financial Additionality

While the test proposed for the RGGI Model Rule would seem simpler than that used in the Clean Development Mechanism, IETA believes it is subject to some of the same flaws and will consequently encounter some of the same problems. Few investment projects are undertaken with a single driving factor in their cost-benefit analysis. At root, the proposed additionality test attempts to assess a project on the basis of intent, measured by financial return, and reward credits according to that intent. A structure such as this is prone to include perverse incentives. Further, it renders investment certainty for business difficult, and as such is likely further to deter desired investment in an offset sector.

IETA also must express concern over the consequential requirement for extensive disclosure of financial information. Without rigorous protection of commercially confidential information, firms considering participation in the RGGI offset market will be significantly deterred by these requirements.

IETA therefore recommends that any test for additionality be firmly guided by the principle of environmental integrity

Compliance

The three-to-one penalty structure is onerous, and regulatory experience elsewhere does not suggest that the extent of the penalty is a critical factor in assuring program integrity. However, the more contentious element of this model regulation is the unique structure under which the penalty applies (XX-6.5(d)(1)). If understood correctly, a given facility faces an absolute cap, beyond which it cannot simply enter the market to secure satisfactory compliance assets.

In XX-6.5(d)(1), if understood correctly, a facility with a minor overage in emissions versus available allowances would be unable to use offsets to make good the excess. Further, by entering into the penalty regime, following the decision rule in XX-6.5 (c)(2)(iii) the non-offset allowances would be drawn from the facility's account first. As offsets are disqualified, the magnitude of the offence is increased not simply by a factor of three-to-one ratio, but against a base of the number of offset credits used.

This structure is fundamentally a demand cap on the emissions allowance market. Demand caps of any form that are independent of the price signal are greatly vulnerable to unintended consequences, and must inherently corrupt the ability of the market to function in setting a price for carbon.

Regulatory Compatibility with Existing US Programs

The overwhelming majority of the facilities covered by the Model Rule are already subject to federal emissions regulation under the acid rain programs. A significant investment in compliance is already in place that could contribute to the success of the RGGI framework. It is therefore unfortunate that the definitions used, such as the definition of a unit for applicability purposes, in the Model Rule are not compatible with those used in the acid rain programs. As such, RGGI is missing an opportunity to minimize the costs and problems associated with monitoring and compliance.

Regulatory consistency with an established emissions trading framework will minimize direct costs of compliance, thereby facilitating investment and contributing to the success of the RGGI initiative. It is questionable whether the additional costs of compliance passed on to all participants are merited by the inclusion of a relatively small number of additional facilities.

Regulatory Compatibility with International Programs

IETA urges the RGGI Staff Working Group to maximize the use of existing standards, in order to embed long-term compatibility within the program while reducing the difficulty of implementation. This could include adoption of the relevant ISO standards, notably ISO 14064 and ISO 14065, within the Model Rule. A similar alternative would be to employ the standard developed jointly by WRI/WBCSD.

We hope our comments will prove helpful, and we thank you for the opportunity to provide them.

Yours truly,

Andrei Marcu
President and CEO
International Emissions Trading Association