Comments of Natural Resources Defense Council
On the RGGI Draft Model Rule

May 22, 2006

The Regional Greenhouse Gas Initiative represents one of the most important policy developments in this nation's fight against global warming to date. If properly designed, RGGI will demonstrate that it is possible to reduce electric sector emissions in a smart way that actually saves consumers money on energy bills, by driving investment in lower cost reductions, promoting the kind of technological innovation that stimulates local economies and capturing all cost-effective energy efficiency.

We would like to thank and congratulate the Governors, Commissioners and staff of the RGGI states, all of whom have shown enormous leadership and commitment and whose hard work over several years is now making RGGI a reality. We hope these comments will help you finalize a Model Rule that delivers on the promise of the MOU and facilitates the creation of a straightforward, credible program that states can implement and enforce with ease and that sets a compelling model for other states and the federal government.

The comments we provide here build on those offered jointly with several other groups by letter dated April 18, 2006.

Stringency of the Cap

States should set the initial regional cap at the level of current regional emissions.

The Model Rule should be designed to ensure that states reduce emissions by 10% from current levels by 2019. As Table 1 in the comments of Environment Northeast makes clear, the proposed initial cap exceeds current levels by over 5%. NRDC recommends that the states reduce the initial regional cap to current levels, or 114 million tons (the average of 2003-2004 emissions), or at least to projected 2009 levels, of approximately 119 million tons. No state has put forth any explanation or justification for beginning with a regional cap that is in excess of current levels or put forth a definition of current levels that corresponds to a number above 119 million.

The Model Rule should not permit any state to inflate the cap by exempting facilities.

The states determined the RGGI cap levels based on the emissions of all sources located in Signatory States that are over 25 MW in size. We do not support exempting any of these sources from the program, but if the Model Rule allows exemptions, it must require any state that exempts a facility whose emissions were included in the calculation of the cap to reduce the state emissions budget by an amount equal to the emissions of such facility. Two provisions in the Model Rule conflict with this principle by allowing states to exempt units that co-fire more than 50% biomass and certain behind the meter units

without requiring states to reduce their budgets to reflect these exemptions. Removing sources from the program without simultaneously backing out their emissions from the cap will artificially inflate the cap and will undermine the objective of stabilizing emissions at current levels and reducing them by 10%. The Model Rule must require any state that chooses to exempt units from the program to reduce its cap by an amount equal to the emissions of such facilities before the launch of the program in 2009.

The Model Rule should allow states to encourage early action without inflating the cap.

The Model Rule provides for early action allowances to promote emission reductions made before program start in 2009. We support state efforts to encourage reductions as soon as possible, but strongly oppose inflating the cap with additional allowances as the means to achieving this goal. Instead, the Model Rule should explicitly provide that a state may issue allowances from its 2009-2019 budgets prior to 2009 to use as incentives for early action provided that a state choosing to do so reduces its annual budget accordingly to reflect such early dispersal.

Offsets

The offsets provision is the first effort by any government to develop a performance standard approach to eligibility, and as such it will have an enormous impact on emissions trading schemes nationwide and internationally. We applaud the states' efforts to develop clear, objective standards for specific offset types and are confident that this approach will result in more credible and robust environmental standards as well as much greater certainty for investors in offset projects. Unfortunately, taken together, all of the provisions related to offsets add up to a system that is about as far away from straightforward as one can get. It is unduly cumbersome and will create tremendous uncertainty in the market place.

The MOU envisions a role for offsets as a buffer against unexpectedly high allowance prices. We propose a simultaneous tightening and streamlining of the program that we believe will allow offsets to serve this role more effectively. The states should (i) limit the geographical location of offsets to Signatory States or states that adopt emission reduction policies comparable to RGGI, unless the $10 safety valve triggers an expansion to a specific list of international emission allowances or credits, and (ii) remove the seven dollar ($7) offsets trigger and limit the numerical expansion to 10% should allowance prices trigger the safety valve.

The states should also ensure that offset protocols are sufficiently precise to support a third party verification system that would require filing with states and a role for state enforcement through spot checks, but that would not require any discretionary decision-making on the part of state agencies and would not allow for any differences in standards among the states, which of course would be untenable in a program in which offsets and allowances are fungible across states.

Geographical and numerical limits for offsets:

Our primary concern regarding the current geographical scope of the offsets provision is that the Signatory States cannot ensure that investments in non-signatory states are real, surplus, verifiable, permanent and enforceable. We also urge the states to limit participation in the offsets market to Signatory States in order to use this opportunity as a carrot to attract new states to join the program. Signatory States should not provide economic benefits to states that fail to do their part to reduce global warming pollution.

Staff have designed the offset protocols to ensure that investments meet the five point test, and they should explicitly state this in the Model Rule, but they must also acknowledge that they only have the information necessary to ensure that the protocols meet this standard in their own states. They cannot ensure that regulations or incentive programs in other states do not undermine this goal. In addition, no Signatory State can enforce compliance with offset rules outside of its borders, but each is assured through the MOU that the other Signatory States will do so.

As currently drafted, Section XX-10.3(g), which requires "access to the physical location of the project for inspection with compliance" is meaningless for projects located outside of Signatory States where no state agency is authorized to conduct spot checks. Therefore Section XX-10.3(h) which would revoke the offset allowances granted to a project would be ineffective, since a state cannot verify continued compliance in non-signatory states. The Model Rule must ensure that if a regulated entity chooses to avail itself of the offset flexibility provisions in lieu of making reductions from a source, the offsets it purchases represent real, surplus, verifiable, permanent and enforceable greenhouse gas reductions from other sectors, and it cannot do this for offsets located in non-signatory states.

The Signatory States could address these concerns if they entered into an MOU with another state or group of states in order to facilitate trading among entities regulated under RGGI and entities regulated under another emissions cap that all Signatory States agree is comparably rigorous to RGGI. An MOU to allow for such inter-system trading could also ensure that offsets in the trading partners' states meet the five point test and the offset rules are enforced.

For international investments, Signatory States cannot ensure that individual projects meet the five point test but they can evaluate the rigor of international trading programs such as the EU ETS and CDM, and could unanimously agree to accept allowances or emission credits from such programs. We recommend that as an initial matter the Model Rule allow only the use of these two currencies in the event that allowance prices trigger the $10 safety valve.

With respect to numerical limits, we believe that the initial 3.3% limit is more than generous and that any increase will undermine the primary purpose of RGGI, to reduce emissions in the electric sector. We would strongly oppose any weakening of that limit. In order to limit disruption to the offsets market, the Model Rule should not allow for more than one expansion and that expansion should not exceed 10%, which represents

the entire emission reduction that the program is designed to deliver. If the Model Rule allows regulated entities to comply with the cap using offsets that represent more than 10% of their emissions, the states will not be able to state that RGGI is reducing emissions in the electric sector.

Offset Triggers:

The safety valve and offset trigger mechanisms are unnecessarily complex and need to be simplified to allow for clear market signals and a functional offsets and allowance trading market, and to mitigate opportunities for gaming. While the use of a price trigger mechanism can provide some degree of price certainty, a second trigger will cause unnecessary confusion in the marketplace. We recommend deleting the provisions that refer to the stage one trigger event and retain only the safety valve trigger for a single, more limited geographical and numerical expansion, as described above. These changes will stabilize the offsets market and remove some of the incentive to game the market that exists with the current provision.

Based on these considerations, we recommend the following:

Base offsets provision:

- 3.3% numerical limit;
- Offsets must be located in
    - Signatory States; or
    - States that have adopted comparable emissions caps and signed an MOU with Signatory States that allows for inter-system trading and ensures that all offsets meet the five point test and the offset rules are enforced.

If the $10 safety valve is triggered, the offset provision expands to:

- 10% numerical limit;
- EU ETS or CDM may be credited as offsets.

Offset eligibility:

With respect to the specific protocols for sequestration, end-use efficiency and agricultural methane, we concur with the comments of Environment Northeast and incorporate them here by reference.

For new offset types, the Model Rule must set forth a clear process for developing the next set of specific protocols, particularly if the states intend to create a regional organization without any real decision making authority to spearhead this effort.

Offset Severability:

The offsets component of the Model Rule is designed to provide flexibility while meeting strict requirements to ensure that greenhouse gas reductions outside of the electric sector are truly equivalent to reductions at power plants. However, regulatory agencies are not required to provide such flexibility measures. The several sections of the offset program within the Model Rule must work jointly to achieve results that guarantee that off-system reductions are real, surplus, verifiable, permanent and enforceable. In other words, the offset program, and all of its provisions, should stand or fall together. The Model Rule should include a severability provision that will render the entire offset provision inoperative should a court find that one part or section of the offsets program is invalid, since in that event the program could no longer meet its intended purposes.

Consumer Allowances

The Model Rule should require Signatory States to ensure that all allowances are used to benefit consumers. As we have previously stated, a free distribution of allowances effectively increases the cost of the program for consumers, will result in windfall profits for most generators and does nothing to advance any program goals. The European Union's experience with the EATS carbon reduction program aptly demonstrates these facts. Modeling done by the states has conclusively shown that proper investments in energy efficiency can reduce or eliminate the cost of the program to consumers while preventing global warming emissions from entering the atmosphere. To the extent that the Model Rule does not require states to distribute allowances in a way that benefits consumers, it should make clear that 25% is a minimum and require states to increase that minimum over time.

The Model Rule must define the terms "consumer benefit" and "strategic energy purpose" to provide guidance to states on how to implement the consumer allowance requirement and to ensure that this provision meets its intended goal of reducing program costs. The Model Rule should specifically provide that states must ensure that consumer allowances are used to promote investments that will reduce the cost of the program for the state's electricity ratepayers and do not pose a significant risk to human health and the environment. It must also specify that proceeds from the sale of consumer allowances cannot displace existing sources of funding for consumer benefits, such as system benefit charges funds that currently support low-income assistance and energy efficiency programs. Such a shell game would make a mockery of this provision and provide no additional value to consumers, effectively increasing program costs.

The Model Rule also must delete any statement that implies a presumption that any state will provide any generator with allowances free of charge. For example, the definition of "allocation" calls for "CO2 allowances to be initially credited to a CO2 budget unit"; elsewhere the Model Rule frequently refers to the allocation of allowances to units. These statements fail to reflect the fact that all states will allocate at least 25% of the allowances to benefit consumers, not units, and at least one state will allocate 100% of allowances to benefit consumers. The definition of "allocation" should be revised, or the term should be deleted and replaced with the word "distribution," and the language

throughout the Model Rule that relates to the distribution of allowances should be revised to reflect the fact that all states may and some states will distribute all allowances to entities other than units in order to benefit consumers.

Voluntary Renewables Market

The Model Rule must ensure that RGGI does not inadvertently harm the voluntary renewables market

The Model Rule should require states to retire allowances in order to support the claims of renewable energy marketers that voluntary purchases will reduce global warming pollution. The voluntary market significantly improves the economics of renewable energy, drives new investment in renewable energy projects in the region and delivers environmental and economic benefits above and beyond what state Renewable Portfolio Standards provide. It is also an integral part of the energy policies and plans for many states, especially New York where the state's 25% renewable energy goal is to be met through a 24% RPS and voluntary renewable purchases totaling at least 1% of the state's energy demand.

To maintain the viability of the voluntary market for renewable energy, the Model Rule should require each state's Regulatory Agency to estimate the size of the voluntary renewable market for the length of each compliance period and subtract the equivalent number of allowances from its cap, to hold in reserve for retirement. At the end of each compliance period, the Regulatory Agency should 'true up' the reserve based on actual renewable energy purchases and then retire the appropriate number of allowances.