

# October 2012 Stakeholder Comments

October 26<sup>th</sup>, 2012

*Developed and endorsed by: ENE (Environment Northeast), Conservation Law Foundation, Natural Resources Defense Council, Appalachian Mountain Club, Chesapeake Climate Action Network, Environment Connecticut, Environment Maine, Environment Maryland, Environment Massachusetts, Environment New Hampshire, Environment New Jersey, Environment New York, Environment Rhode Island, Environmental Advocates of New York, New York Public Interest Research Group, and Northeast Energy Efficiency Partnerships*

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Our organizations welcome the opportunity to submit initial comments on program design concepts for the new Regional Greenhouse Gas Initiative (RGGI) Model Rule, and we look forward to continuing engagement as states consider improvements to RGGI.

We believe recommended changes offered below are necessary to ensure RGGI delivers on the promise of reducing GHG emissions from the electric sector in the region while maintaining the environmental integrity of the program. These changes would also enable RGGI states to use state climate programs as compliance mechanisms for future federal regulations of Greenhouse Gases from existing power plants and to further explore linking with other states such as California. Without addressing the over-allocated cap and the existing bank of allowances in a manner that ensures the environmental integrity of the program, RGGI would most likely not be useful for these purposes.

Before addressing topics raised in the latest webinar and request for stakeholder comments, it bears noting that changes to RGGI's price controls, offsets mechanism, and other modifications must be predicated on updating the emissions cap and addressing the surplus of banked allowances. Emissions in the first half of 2012 fell to a historic low of 41 million tons, 20% below 2011 levels.<sup>1</sup> If this trend continues for the remainder of 2012, emissions are projected to reach only 85 million tons, or 49% below the current cap.<sup>2</sup> In light of continuing low emissions in the region, and the current availability of excess allowances in the market, program modifications intended to reduce volatility will have no practical impact unless and until states adjust the fundamental imbalance of supply and demand to create a robust RGGI market.

In modeling the economy wide impacts of RGGI changes it is important to recognize that macroeconomic impacts relate directly to the use of auction proceeds. Investment of these proceeds should maximize consumer benefit, particularly through investment in energy efficiency. Analysis of RGGI's economic impact to date shows that all states have benefitted from the program,<sup>3</sup> and projections based on the last round of emissions modeling show that states could add an additional \$11.3 billion in value to their economies and generate 80,000 job years of employment by resetting the cap and continuing to invest in energy efficiency and other state programs.<sup>4</sup>

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<sup>1</sup> Data from RGGI CO<sub>2</sub> Allowance Tracking System, at: <https://rggi-coats.org/eats/rggi/>

<sup>2</sup> ENE projection based on average (49%) contribution of first and second quarter emissions in 2009-2011 to annual 2009-2011 emissions (i.e. projected 2012 emissions assumes a similar distribution of emissions over the course of the year as in previous years of the RGGI program).

<sup>3</sup> Analysis Group report *The Economic Impacts of the Regional Greenhouse Gas Initiative on Ten Northeast and Mid-Atlantic States* found that investment of RGGI revenue in energy efficiency contributed the greatest portion of the \$1.6 billion in net benefits from the program, see: <http://www.analysisgroup.com/RGGI.aspx>

<sup>4</sup> See ENE's Current and Potential Benefits of RGGI, available at: [http://www.env-ne.org/public/resources/ENE\\_RGGI\\_Economic\\_Benefits\\_20120920.pdf](http://www.env-ne.org/public/resources/ENE_RGGI_Economic_Benefits_20120920.pdf)

## **Treatment of Unsold Allowances**

The discrepancy between emissions and the RGGI cap has led to significant quantities of allowances going unsold at auction. If these allowances are not removed from the system, a revised cap could be inflated above its nominal level, undermining RGGI's effectiveness and the program's contribution to the economy-wide emissions reduction requirements in place for 9 of the 10 RGGI states.<sup>5</sup> This has significant implications for RGGI's long-term future and any potential in the near term for expanding the program to other jurisdictions or linking with other cap-and-trade programs. Unsold allowances should thus be retired at the end of each year, and states should announce their intentions to retire unsold allowances at the beginning of each year.

RGGI states should also consider how to deal with the problem of surplus allowances before the changes to RGGI take place. Without addressing this problem, changes announced now to deal with the current cap over-allocation could prompt market participants to purchase surplus allowances at current prices, which would exacerbate the banked allowance problem. Not addressing this problem will also invite significant participation of market speculators who could purchase cheap allowances before market changes take place and sell them quickly afterwards. States need to clearly signal that surplus allowances will not be permitted to undermine the new cap, potentially by announcing that allowances from the new cap will be retired in proportion to the bank (mechanics elaborated below). Alternatively, states could announce that all allowances sold after a certain date will expire at the end of this compliance period.

## **Consideration of Banked Allowances and Potential Cap Changes**

As RGGI states consider adjusting the cap to account for the enduring decline in emissions, the existence and potential impact of the privately-held allowance bank must be taken into account. Modeling of cap level adjustments proposed by the states illustrate that a declining cap level does not produce emissions reductions from regulated sources if the large quantity of banked allowances remains available for compliance. Modeling presented by the states at the March 20<sup>th</sup> stakeholder meeting (Figure 1, below) depicts the expected impact of the lowest cap level adjustment on emissions from regulated facilities. In this scenario the cap is adjusted from 165 million tons to 106 million tons, with no offsets used for compliance. While this cap adjustment appears significant, because the allowance bank still exists from prior years, emissions actually continue to rise over the period modeled.<sup>6</sup>

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<sup>5</sup> All RGGI states, with the exception of Delaware, have mandated GHG emissions reduction targets. It is critical for the states at a minimum to calibrate that the quantity of RGGI allowances (emissions) to their respective emission reduction requirements. For additional details on state emissions reduction targets see:

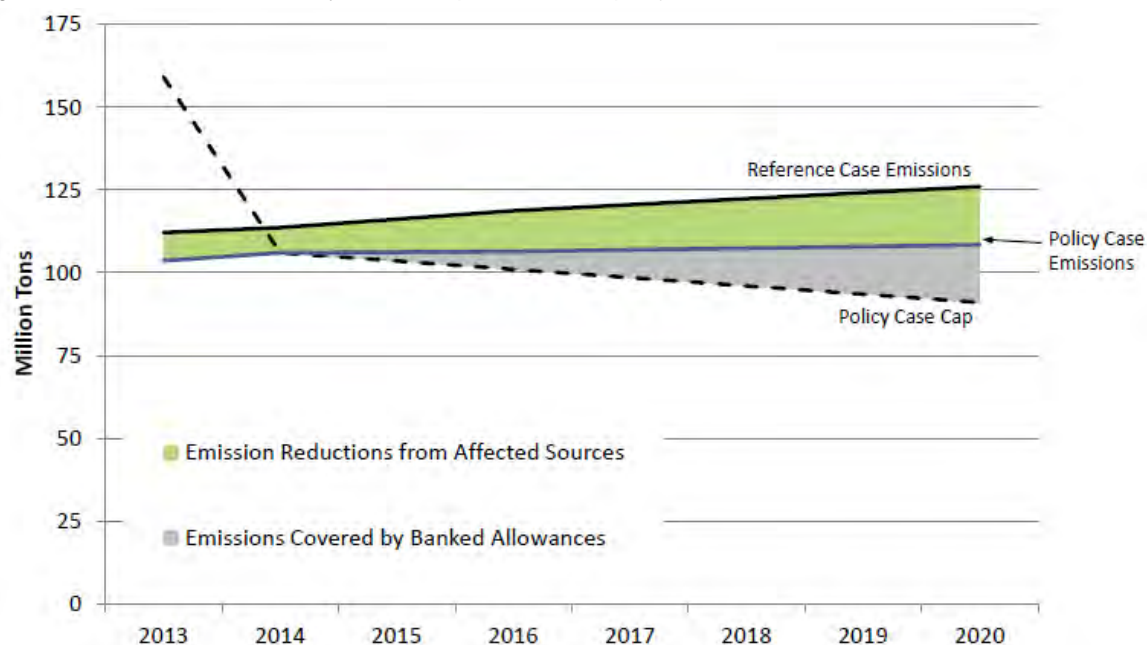
[http://www.pewclimate.org/what\\_s\\_being\\_done/targets](http://www.pewclimate.org/what_s_being_done/targets)

<sup>6</sup> The potential for the allowance surplus to undermine RGGI's capacity to reduce emissions was additionally described by Olga Chistyakova of PointCarbon at the 9/20/11 RGGI stakeholder meeting; presentation at:

[http://www.rggi.org/docs/RGGI\\_Stakeholder\\_Presentation\\_Thomas\\_Reuters\\_Point\\_Carbon.pdf](http://www.rggi.org/docs/RGGI_Stakeholder_Presentation_Thomas_Reuters_Point_Carbon.pdf)

**Figure 1: Modeling Output of 106 Cap with Cost Containment Reserve and No Offsets<sup>7</sup>**

Note that emissions continue to increase through 2020, primarily due to the allowance bank, which was projected to grow to 97 million allowances by 2014 in expectation of cap adjustment.



A straightforward means by which states could account for the private bank is by retiring allowances equivalent to the bank at the time of cap adjustment. Using a pre-determined formula, states could quantify the size of the bank at the time of cap adjustment and proportionally retire a pool of allowances drawn from the new cap. If the allowances are drawn in equal measure from each annual budget of the new cap, states could maintain stable funding levels, and the compliance value of privately banked allowances would be preserved.

*For example, if a private bank of 70 million allowances exists when the new cap comes into effect at the start of 2014, states would collectively retire 70m allowances, with 10m drawn from each of the 7 years of the new cap. The actual number in each state would be determined in proportion to each state's share of the regional cap (e.g. if Maryland is 23% of cap, then Maryland would retire 2.3 million allowances from each year's allowance budget).*

## Compliance Period Changes

In prior stakeholder comments we indicated support for modifications of compliance obligations to the extent that they facilitate compliance, reduce price volatility, and enable linkage with other market-based climate programs.<sup>8</sup> Experience with the bankruptcy of AES Eastern Energy suggests that interim compliance obligations may become increasingly relevant and necessary as aging coal plants face increased market pressure from lower cost natural gas units and low electricity prices. If emitters are required to surrender allowances proportional to a share of their annual emissions, non-compliance could be addressed in a more timely manner than if allowances are only due every three years.

<sup>7</sup> Available at: Source: [http://www.rggi.org/docs/ProgramReview/March20/IPM-Modeling\\_030212.pdf](http://www.rggi.org/docs/ProgramReview/March20/IPM-Modeling_030212.pdf)

<sup>8</sup> See: [http://rggi.org/docs/ProgramReview/StakeholderComments/SC053112\\_Joint-Environmental-Orgs.pdf](http://rggi.org/docs/ProgramReview/StakeholderComments/SC053112_Joint-Environmental-Orgs.pdf)

## Cost Containment Reserve

While establishing a cost containment reserve (CCR) would ostensibly help to reduce price volatility and thus facilitate meaningful adjustment of the emissions cap, it is important to recognize that a large quantity of allowances are already available in the market today – much larger than the amount of allowances that could be introduced via a CCR. RGGI, and every cap-and-trade program operating today, has been designed for compliance entities to engage in “trades” of these allowances where necessary. Before considering creation of an additional flexibility mechanism, states need to (1) lower the cap and (2) reduce available extra allowances.

Additionally, states must ensure that the CCR preserves RGGI’s environmental integrity and builds on best practice from other market-based climate programs. RGGI’s environmental integrity is important not only because the program’s goal is to reduce emissions, but because RGGI needs to serve as a key component of state requirements to reduce GHG emissions economy-wide (as discussed in footnote 5). States can safeguard environmental integrity by drawing CCR allowances from under the cap and setting CCR price thresholds well above projected market prices. When allowances are drawn from under the cap, the total quantity of allowable emissions remains fixed over the duration of the program, ensuring achievement of RGGI’s targets, and providing reasonable notice to market participants of the overall availability of allowances in the RGGI market. Conversely, adding CCR allowances on top of the cap essentially establishes a second, inflated RGGI cap. A CCR reserve of 10 million allowances each year of the seven years in the revised program would add a total of 70 million allowances to the RGGI program – potentially inflating the cap by over 10%. States should replace the current approach with a fixed quantity of allowances drawn from under the cap. As described by Professor Brian Murphy at the January 24<sup>th</sup> learning session, a small supply of allowances is sufficient to meet incremental increases in allowance demand and suppress price increases, with a reserve of 1%-3% of the cumulative emissions limit sufficient to protect against price risk.<sup>9</sup> States could use modeling to determine the appropriate size of the CCR, noting that the recently developed California program has a reserve filled with 4% of cumulative allowances, drawn from under the cap.

Prices for allowances sold from the strategic reserve should be high enough to preserve the market signal to reduce emissions, and it is unlikely that the \$5-\$10 range of proposed reserve prices would support this objective. Additionally, the periodic increase in proposed CCR prices seems somewhat arbitrary and unpredictable for market participants and investors developing lower-carbon sources or power. In order to address these issues, the price threshold for reserve allowances should be set higher than the projected market price in 2014, and increase annually by 5% plus the rate of inflation. An annual price adder is needed to ensure that the market for RGGI allowances functions rationally and does not lead to speculative allowance purchases or distort emission reduction incentives. As discussed by Burtraw and Woerman in Resources for the Future (RFF) October 26, 2012 stakeholder comments,<sup>10</sup> the prices at which the ceiling (CCR) and floor (reserve price) are set needs to account for the opportunity cost of capital, or discount rate, in order to harmonize financial incentives for emitters and other market participants with desired emissions and economic outcomes in the RGGI system. Not incorporate a discount rate in setting price controls could encourage speculation in RGGI allowances or distort emissions reduction incentives, increasing program costs in the short or long term. It is worth noting that the California cap and trade system includes a price adder of 5% plus inflation both for the floor and ceiling prices, as did federal cap and trade proposals.

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<sup>9</sup> See [http://rggi.org/docs/ProgramReview/LearningSession2/Murray\\_120124.pdf](http://rggi.org/docs/ProgramReview/LearningSession2/Murray_120124.pdf)

<sup>10</sup> Available at: [http://rggi.org/design/program\\_review/stakeholder\\_comments](http://rggi.org/design/program_review/stakeholder_comments)

In the interest of simplicity and market openness, we support selling allowances through the existing quarterly auction infrastructure. Reserve auctions should be open to all interested participants to maintain liquidity and ensure that the value of allowances is returned to the public rather than being purchased and resold at higher prices to entities excluded from CCR purchases.

### **Flexibility Mechanism Triggers**

In the interest of simplicity the current offset usage triggers should be removed, and offset usage should be limited to 3.3% of compliance obligations, using only domestic offsets. Establishing a CCR would make the current offset triggers irrelevant, obviating the need for additional triggers.

### **U.S. Forest Offset Protocol**

In light of the importance of forests in the carbon cycle we support the development of a US Forests Offset Protocol. Sustainably managing forests to increase carbon storage, and conserving forests threatened with development would help address climate change while building on the natural resource base in the RGGI region. In addition to reducing greenhouse gases and potentially providing revenue through an offset system, improved forest management and forest conservation also have substantial co-benefits, in the form of clean water, biodiversity protection, and more resilient forests. There are 44.25 million acres of privately-owned timberland in the 10-state RGGI region. An economic analysis commissioned by The Nature Conservancy and Winrock International found that up to 23.9 million Mt CO<sub>2</sub>e of present value carbon could be sequestered in the region for \$10/Mt CO<sub>2</sub>e.<sup>11</sup> Loss of forest land to other non-forested uses is a large problem in the Northeast, and threatens the long-term ability of the region's forests to remove carbon dioxide from the atmosphere. Within the RGGI region, approximately three hundred thousand acres of forest land were converted to other non forested uses between 1997 and 2002. This conversion has resulted in approximately 105 million MtCO<sub>2</sub>e of greenhouse gas emissions. If not properly managed or conserved, the region's forests can actually be a net source of emissions, as was the case between 1998 and 2001 within the New England states.

We believe that the California Air Resources Board (ARB) forest protocols for afforestation, improved forest management and avoided deforestation provide a robust template for increasing carbon sequestration from northeast forests, consistent with a proposal by Maine Forest Service (MFS), Maine Department of Environmental Protection, the Manomet Center for Conservation Sciences, and ENE submitted to RGGI in 2009. A RGGI forest offset protocol should conform to existing RGGI offset requirements for additionality, verification, and the application process. RGGI may need to diverge slightly from the California approach of creating a forest offset buffer to account for inherent project risk of carbon release through fire, pest infestation or other unintentional reversals. In the RGGI context setting up a buffer account across states could present

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<sup>11</sup> Sohngen, B., Walker, S., Grimland, S. and S. Brown. 2007. Terrestrial Carbon Sequestration in the Northeast: Quantities and Costs. Part 4. Opportunities for Improving Carbon Storage and Management on Forest Lands. [http://www.winrock.org/ecosystems/files/Opportunities\\_for\\_improving\\_carbon\\_storage\\_and\\_management\\_on\\_forest\\_lands.pdf](http://www.winrock.org/ecosystems/files/Opportunities_for_improving_carbon_storage_and_management_on_forest_lands.pdf)

legal complications, and in-state buffers could be too small to adequately cover risk, particularly if only a small number of projects are developed in a state. RGGI states could instead discount forest offsets at the point of registration to account for project risk, with forest types categorized to reflect specific risk factors, using the same formula as ARB. RGGI states must also recognize that the ARB forest protocol is designed primarily for industrial-sized forest tracts, and that improving opportunities for small landholders to enhance carbon sequestration would be beneficial for the climate and for the region. RGGI should pursue the objective of including small landholders in collaboration with California and within RGGI offset protocols.

Beyond the forest offset protocol RGGI states should revisit this issue of offset project risk by requiring entities using offsets for compliance to replace offsets invalidated due to reversal or fraud. California has adopted such an approach to ensure that the offset market is designed to promote offset quality, and RGGI states would benefit from following this best practice while taking an important step toward harmonizing with the California market.

### **Reserve Price**

The comments sent to the states by the group organized by the Pace Energy and Climate Center indicate that those stakeholders are interested in modeling reserve prices at \$5, \$7.50 and \$10. These prices merit consideration by the states, as they would likely stimulate offset markets, drive additional emissions reductions and enhance the viability of linking with California. Furthermore, RGGI states should look to reserve prices set by the California climate program and current price of allowances for the program recently launched in China (60 Yuan ~ \$9.60) as examples of current carbon market program design. Additionally, the present approach of setting the “current market reserve” price for allowances should be replaced with an annual escalator of 5% plus CPI. The 2.5% annual price adder proposed by RGGI states is insufficient to reflect the opportunity cost of capital, and could distort RGGI allowance prices and market behavior, as discussed above in relation to the CCR, and in stakeholder comments by RFF.<sup>12</sup>

### **Early Reduction CO<sub>2</sub> Allowances**

We support the deletion of Early Reduction CO<sub>2</sub> Allowance language from the RGGI Model Rule as the provision is no longer relevant.

Thank you for the opportunity to provide input to the development of a new RGGI Model Rule, and we look forward to continuing engagement in the RGGI Program Review.

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<sup>12</sup> Available at: [http://rggi.org/design/program\\_review/stakeholder\\_comments](http://rggi.org/design/program_review/stakeholder_comments)