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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: Comments Of The Northeast Suppliers On The RGGI Auction Design
Final Report

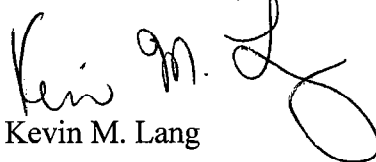
Ladies and Gentlemen:

In accordance with the notice issued on the Regional Greenhouse Gas Initiative ("RGGI") web site regarding the November 7, 2007 Stakeholder meeting and the solicitation made by the Staff Working Group at that meeting, the Northeast Suppliers hereby submit their comments on the "Auction Design for Selling CO₂ Emission Allowances under the Regional Greenhouse Gas Initiative – Final Report."

If you have any questions, please feel free to contact me at the above telephone number.

Sincerely yours,

GREENBERG TRAURIG, LLP


Kevin M. Lang

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Enclosure
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COMMENTS OF THE NORTHEAST SUPPLIERS ON THE RGGI AUCTION DESIGN FINAL REPORT

In accordance with the notice issued on the Regional Greenhouse Gas Initiative (“RGGI”) web site regarding the November 7, 2007 Stakeholder meeting and the solicitation made by the Staff Working Group at that meeting, the Northeast Suppliers hereby submit their comments on the “Auction Design for Selling CO₂ Emission Allowances under the Regional Greenhouse Gas Initiative – Final Report” (“Final Report”).¹ Throughout the RGGI Stakeholder Process, the Northeast Suppliers have emphasized that a properly structured allowance auction is essential to the continued reliability of the electric system in the RGGI States and achievement of the RGGI goals.

While the Final Report discusses some of the concerns raised by the Northeast Suppliers in their comments on the Phase I Interim Report, additional analysis and consideration of certain auction design and related issues is necessary, as discussed below. The Suppliers appreciate the continuing opportunity to provide input and assist the RGGI States in designing their CO₂ emissions allowance auctions and developing their allowance auction rules.

1. The Northeast Suppliers Support The Recommendations Regarding The Choice Of Auction Type And Frequency

In the competitive wholesale electric markets, it was determined that sealed bid, uniform price auctions provided the most efficient method of selling the products that together comprise

¹ The Northeast Suppliers are comprised of the following companies: AES Eastern Energy, L.P., Brooklyn Navy Yard Cogeneration Partners, L.P., Dynegy Northeast Generation, Inc., the Indeck Companies, Lockport Energy Associates, L.P., the NRG Companies, PSEG Power, LLC and US Power Generating Company, LLC. The Indeck Companies are Indeck-Corinth, LP; Indeck-Olean, LP; Indeck-Oswego, LP; Indeck-Yerkes, LP and Indeck Energy Services of Silver Springs. The NRG Companies are NRG Power Marketing, Inc., Arthur Kill Power LLC, Astoria Gas Turbine Power LLC, Dunkirk Power LLC, Huntley Power LLC, and Oswego Harbor Power LLC.

the commodity of electricity. The Research Team's recommendation to use the same type of auction for the RGGI program is significant in that it represents independent confirmation of and support for the competitive electric market approach. For the reasons set forth in the Final Report, the Northeast Suppliers support this recommendation and encourage the RGGI States to adopt this auction format.

Similarly, the Northeast Suppliers support most of the recommendations set forth in Chapter 5 of the Final Report on auction frequency, timing, and size. Quarterly auctions properly balance the needs of the generators with the costs of the auctions and should, subject to the foregoing discussion, ensure sufficient liquidity in the secondary markets. Similarly, the proposal to sell each vintage of allowances in eight equally-sized auctions over a five-year period appears to be reasonable and should provide sufficient opportunities for generators to acquire the allowances they need while reducing the potential for short-term circumstances to unduly influence any vintage's clearing price(s). The Northeast Suppliers acknowledge and appreciate that the Research Team and Staff Working Group incorporated the generators' concerns and preferences in developing the recommendations on these issues.

As more fully discussed below, the Final Report's analysis of the need for joint auctions and identical allowances throughout the RGGI region is also meritorious and the associated recommendations should be adopted. The Northeast Suppliers recognize that much work is needed to achieve and implement these particular recommendations, and they are encouraged that the Staff Working Group is already addressing this matter. The Northeast Suppliers urge the agency heads to quickly reach consensus on this point so that the benefits of a joint and uniform auction, as identified in the Final Report, can be realized.

2. The Auction Should Be Consistent With The Construct Of A Cap And Trade Program

According to the RGGI Memorandum of Understanding (“MOU”) and information provided on the RGGI web site, RGGI is comprised of two components – a cap and trade program and an emissions trading system. The RGGI web site explains that a cap and trade program operates by setting a total emissions cap, creating emissions allowances that sum to the cap, and allowing companies to trade the allowances. The web site further explains that a cap and trade program provides flexibility to companies (*i.e.*, generators) to cost-effectively reduce their emissions.²

The MOU was the result of a more than two-year Stakeholder Process that included extensive meetings with and input from stakeholders, the preparation and critical assessment of numerous technical studies and economic analyses, and presentations by a variety of subject matter experts. Models were created to, among other things, estimate the potential cost of the allowances over time and the impact of the program on retail electricity prices and consumers’ electric bills. Based on the information developed through that process, the governors of the RGGI States executed the MOU and directed their executive agencies to move forward with implementation of the RGGI program.

The program now being contemplated in the Final Report and the proposed RGGI regulations in New York and elsewhere depart substantially from a cap and trade program structure. Whereas the proposed RGGI program sets aside nearly all of the allowances for the auction, no previous cap and trade program in the RGGI States has set aside more than 10% of the allowances. As such, it is critical that these rules be designed to ensure that the allowances necessary for compliance will be available to generators to ensure that the facilities that are

² See http://www.rggi.org/def_cap.htm.

needed to provide electricity to consumers can be operated. In addition, if a reserve price is imposed, as recommended by the Final Report and contemplated in the proposed RGGI regulations issued by some of the RGGI States (but not included in the MOU), the number of allowances available could be artificially limited, effectively creating a new, lower emissions cap. Generators would no longer have the same clear and constant target as that set forth in the MOU against which to measure their progress in reducing their CO₂ emissions.

The combination of a reserve price and the creation of a contingency bank of unsold allowances would artificially restrict the number of allowances available for trading, thereby hindering the second fundamental component of a cap and trade program. Further, the combination could create an unintended conflict in the goals and principles of the MOU. That is, the intent of the MOU is to stabilize and reduce CO₂ emissions in the RGGI States while “maintaining a reliable electric system in the region, and . . . ensur[ing] that the Program will not result in electricity supply interruptions.”³ If the generators cannot obtain enough allowances to offset their CO₂ emissions, they may be forced to reduce their output in order to avoid the draconian penalties for noncompliance set forth in the proposed regulations. Depending on when and where those reductions occur, the reliability of the electric system could be jeopardized.

Moreover, under a traditional cap and trade program, generators expect their compliance costs to go down over time as they implement permanent measures to control their emissions. As the number of allowances they need declines, and the delta between the total number of allowances needed and the annual emissions cap set forth in the MOU grows, the value of each allowance, and the secondary market clearing price, should correspondingly decline.

³ MOU, Sections 1 and 6.B.

Because there are no criteria, details, or specific procedures as to whether or how the reserve price should be set, tremendous uncertainty and concern regarding the level of the reserve price have been injected into this process. Specifically, there are no provisions in place or proposed to ensure that the reserve price does not artificially inflate the auction clearing price initially or over time. It is possible that if the reserve price is set in a manner that does not recognize the declining value of the allowances over time, it would effectively penalize the generators for increasing the efficiency of their facilities because the allowances they would still need would become more expensive. The effect of an improperly set reserve price, in addition to disrupting the economic efficiency of the auction process, would therefore be to diminish the generators' motivations to invest in new technologies and other activities as their total compliances would remain the same or possibly increase.

Further, the models and analysis on which the MOU and the emissions caps were based, and on which the RGGI States' governors decided to proceed with the RGGI program, did not assume a reserve price or an auction of almost all of the allowances. The electricity price and bill impacts presented to the governors, the general public, and the stakeholders did not reflect a tighter emissions cap than that set forth in the MOU or the potential increase in allowance costs associated with the use of a reserve price.⁴ It is likely that the introduction of these new factors, in addition to the impacts stated above, will result in greater consumer impacts.

⁴ According to the RGGI web site, http://www.rggi.org/agreement.htm/mou_rggi_overview_12_20_05.pdf, the "[p]rojected retail electricity price impacts would be modest under the 'best estimate' scenario, ranging from an increase of 0.3% to 0.6% in 2015, across all rate classes. Under a 'high emissions' reference case scenario, projected retail electricity price impacts range from 1.7% to 3.2% in 2015, across all rate classes. . . . Projected direct electricity bill impacts due to RGGI range from \$3 - \$16 per average household annually in 2015.[footnote omitted]." According to the New York State Department of Environmental Conservation's web site, <http://www.dec.ny.gov/energy/39282.html>, "[e]conomic models . . . project that the price per allowance will be \$2/ton in 2009 . . . , [which] projections are considered accurate." A higher allowance price will likely directly translate to larger electricity price and bill impacts.

Accordingly, the construct of the RGGI program should remain consistent with the principles and goals set forth in the MOU.⁵ In particular, the program being implemented in each RGGI State should include a clearly articulated and firm cap and permit the unfettered trading of all allowances.

3. There Is No Need For A Reserve Price

In addition to the overall concern with the use of a reserve price discussed above, there are other reasons why a reserve price is unnecessary. The Final Report and Professor Shobe (at the Stakeholder meeting) explained that the purpose of a reserve price, generally, is to protect against collusion. The Northeast Suppliers respectfully submit that: (i) the concerns about collusion and the need to protect against it are unfounded; and (ii) there are other, superior methods to protect against market manipulation, as discussed below.

The Northeast Suppliers do not dispute that, in theory, there could be collusion in an auction process. They also do not dispute that in simplistic laboratory experiments involving a very small number of participants, collusive behavior could occur. In translating that academic research to the RGGI program, the Staff Working Group and agency heads need to temper the laboratory results with real-world facts and market factors.

⁵ In testimony before the U.S. House of Representatives Select Committee of Energy Independence and Global Warming on November 14, 2007, Governor Spitzer reaffirmed those principles and goals, explaining that the cap for New York State will be at the level set forth in the MOU, that “New York will auction 100 percent of available allowances, . . . [and] [g]enerators will then be able to buy and sell allowances in a secondary market.” Testimony, p. 3. The Governor also reaffirmed the validity of the initial forecasts of the allowance costs and bill impacts: “With regard to the cost impact of implementing the RGGI program, our modeling shows that cost impacts will be low. Carbon dioxide allowance prices—the cost of complying with RGGI—are projected to increase from approximately \$2 per ton in 2009 to about \$3 per ton in 2015 and about \$4.45 per ton in 2021. . . . our modeling shows that these impacts will be negligible. For a typical New York residential customer (using 750 KWh per month), the projected increase in wholesale electricity prices in 2015 translates into a monthly retail bill increase of about 0.7 percent or \$0.78.” *Id.*

It is highly doubtful that there will be only six or 12 participants in any allowance auction. Rather, the auctions are likely to attract dozens, if not hundreds, of participants.⁶ These participants are likely to have vastly different interests in the CO₂ allowance market – some may desire low prices, others may desire high prices, and others may be indifferent to the price. Given the composition and number of market participants, the likelihood of collusion (tacit or otherwise) from occurring is greatly diminished from the likelihood seen in the Research Team’s rigidly controlled laboratory environment. To the extent prices decline over time, that outcome will presumably be attributable to factors including, but not limited to, the natural results of price discovery, reduced risk and uncertainty with the process, and a reduced need for allowances (due to, for example, fuel switching, construction of new, efficient generating facilities that supplant older, less efficient facilities, and to the extent they become commercially viable, the implementation of new technologies).

Experiences in other emissions markets demonstrate that, during their initial phases, uncertainty, risk, and the absence of information cause allowance prices to spike. As price discovery occurs, the prices decline and then stabilize.⁷ Thereafter, any number of factors can influence the auction price. The Northeast Suppliers are not aware of any allegations that collusive activity has been identified as one of those factors.

In contrast, IETA notes that the auctioning of 100% of the allowances could itself be a significant factor in driving the auction clearing price.⁸ Evolution Markets, Inc. has a similar

⁶ In New York alone, there are over 30 generators that need to purchase allowances to offset their emissions.

⁷ See, e.g., Comments of the International Emissions Trading Association’s U.S. Working Group (“IETA”), submitted to the New York State Department of Environmental Conservation on its RGGI regulation pre-proposal (“IETA Comments”). IETA provides details on price changes for three emissions programs that demonstrate this pattern.

⁸ *Id.* at p. 8.

view. They observed that price distortions in the SO₂ program were caused by auction-related expectations, and they made no mention of collusion as a cause of the price fluctuations.⁹

With respect to the need for a reserve price to protect against market manipulation, the Northeast Suppliers submit that if an entity attempts to manipulate the market price of allowances, such improper behavior should be addressed directly. By way of analogy, Professor Shobe discussed a situation involving an entity that attempted to manipulate the price of U.S. Treasury securities through hoarding. The government directly addressed that entity's conduct; it did not indirectly attempt to remedy the improper behavior by influencing subsequent auction prices.

Moreover, a reserve price should not be used, as it is apparently being proposed here, as a substitute for effective market monitoring. As also discussed below, a properly structured market monitoring program should quickly and efficiently identify and address any attempts at collusion. For this program, especially, a reserve price is a poor substitute because of its undesirable corollary effect of potentially artificially inflating the auction clearing price of the allowances.

To the best of the Northeast Suppliers' knowledge, none of the other emissions markets now in existence include minimum prices for their allowance auctions. The absence of reserve prices does not appear to have caused problems in those markets, and there have not been any reports of collusion attributable to the lack of a reserve price. To the contrary, and as noted above, the prices fluctuate over time in accordance with the changing value of the products auctioned and traded.

⁹ See Testimony of Andrew Kruger, Vice President of Evolution Markets, Inc., before the New York State Department of Environmental Conservation ("NYSDEC"), dated December 14, 2006, p. 2.

Similar experiences exist in the wholesale electric markets, where virtually all of the products available are sold via auctions. Those auctions occur daily, monthly, seasonally, and annually. One common element to all of the auctions is that none have reserve or minimum prices. In fact, under certain circumstances, the price of a product in an auction could fall to zero (*e.g.*, capacity) or even go negative (*e.g.*, energy). In the wholesale markets in which the RGGI States are located, there have been no reports of widespread collusion resulting from the absence of reserve prices. Another common element to those auctions is that they all have bid caps to prevent undue volatility and price spikes that would be harmful to consumers.

The RGGI web site describes the RGGI program as “. . . a flexible, market-based approach to achieving real emissions reductions at the lowest possible cost.”¹⁰ As Professor Shobe acknowledged, if not set properly, a reserve price can create an artificial minimum price for the allowances. The RGGI States should heed Professor Shobe’s warning and refrain from implementing RGGI in a manner that substitutes administrative for market-based allowances valuations.

4. In The Event The Decision Is Made To Set A Reserve Price, The Stakeholder Process Should Be Used To Develop An Appropriate Methodology For Doing So

If the RGGI States nevertheless decide to move forward with the use of a reserve price, that price must be designed to ensure that it cannot affect the market price of the allowances. That is, safeguards should be included in the governing regulations and all other controlling documents to ensure that the reserve price is not used to influence or otherwise artificially inflate the value the allowances.

¹⁰ [http://www.rggi.org/agreement.htm/mou_faqs_12_20_05\[1\].pdf](http://www.rggi.org/agreement.htm/mou_faqs_12_20_05[1].pdf), p. 2.

In particular, the calculation of the reserve price should be guided by the same economic assumptions and conclusions that formed the basis of the MOU and the Model Rule. ICF Consulting's ("ICF") Integrated Planning Model® was used to develop the economic forecasts and impacts of the RGGI program, including the electricity price and bill impacts cited above. As noted, it appears that the RGGI States still endorse the validity of ICF's analysis.¹¹ Accordingly, ICF's estimate of the allowance prices (*i.e.*, \$2 through 2012, then scaling up to \$4 in 2018 and remaining at that level through 2021) should form the basis for any reserve price.¹²

Due to the relatively late introduction of this concept,¹³ and because of the vagueness of the Final Report and proposed regulations on the methodology by which a reserve price should be set, it is difficult to offer any other substantive response on this topic in these comments. Instead, the Northeast Suppliers recommend that the Staff Working Group resume the Stakeholder Process and work with the stakeholders to develop the details, standards, and parameters for a reserve price methodology.

Because of the potential ramifications for the RGGI program, and, more importantly, the reliability of the electric system and consumers' electric bills, if a poorly designed methodology is implemented, it is imperative that great care be taken in developing the methodology. As acknowledged at the Stakeholder meeting, the Research Team has not offered any specific recommendations on, and the Staff Working Group does not yet have any specific proposals for,

¹¹ If the RGGI States no longer agree with ICF's analysis, then in fairness to the stakeholders and the citizens of the RGGI States, a revised economic analysis should be performed and the revised potential impacts disclosed prior to the commencement of the RGGI program.

¹² For example, one essential parameter of the methodology is that the reserve price should be substantially less than ICF's forecast of the allowance prices so as not to inadvertently influence the market price or market participants' behavior.

¹³ It should be noted that there is no mention of a reserve price in either the Model Rule or the Pre-Proposals circulated by some of the RGGI States.

setting the reserve price. Under these circumstances, it is premature to proceed with finalization of the auction design or adoption of the proposed regulations.

Resuming the Stakeholder Process will maximize the ability of the Staff Working Group to obtain input on what would be a critical auction design feature. The use of the Stakeholder Process will allow for in-depth consideration of this matter, including identification of the myriad pitfalls and potential problems and development of a sound and well-reasoned approach.¹⁴ The resulting clearly defined rules and procedures for setting a reserve price will promote transparency and economic efficiency in that all market participants will have the same understanding of how the auctions will be conducted presently and in the future, and the market will appropriately determine the value and price of the allowances.

In addition to rules on the parameters and details of the methodology, rules should be established regarding the frequency that the reserve price can be changed, symmetrical protections against market manipulation that causes the auction clearing price to exceed the value of the allowances (discussed in detail below), and the procedures to be undertaken or implemented if market monitoring activities identify that the use of a reserve price is impinging on the proper functioning of the emissions trading market.

5. There Is No Reason For the RGGI States To Withhold Allowances In A Contingency Bank

As discussed in Section 2, the stated intent of the RGGI States is to create a market-based cap and trade program. Further, as acknowledged by the Staff Working Group at the Stakeholder meeting, the purpose of the RGGI program is not revenue generation. For these

¹⁴ As one example of the issues to be addressed, if the demand for allowances shrinks and the market price decreases, the reserve price should not be prohibited or restricted from correspondingly decreasing. Any constraints on the movement of the reserve price would lead to economic inefficiencies and violate the criteria on which the auction design and the RGGI program are premised.

reasons, there is no legitimate reason to withhold allowances from the market in a contingency bank unless and until a subjectively-determined price threshold is surpassed that has no relationship to the value placed on the allowances by the market. Rather, the market should be permitted to dictate how many allowances are needed and at what value/price.

According to the principle of economic efficiency, and as demonstrated by the Research Team's laboratory experiments, generators who value the allowances at less than the clearing price would reduce or cease their purchases in the early auctions. As the end of each three-year compliance periods draw near, though, the generators will need to ensure that they acquire sufficient allowances to offset their emissions. If the supply of allowances has continually shrunk because the unsold allowances were placed in a contingency bank after each auction, the increasing demand will cause the price of the allowances which have been released into the market to rise. Under the contingency bank proposal, market clearing prices for the available allowances would be forced to the price threshold before the artificial restriction on available allowances is lifted. Thus, the only thing achieved by the contingency bank is to artificially increase allowance prices above their market-based value.

To ensure economically efficient results, including that allowance prices equal their value, all allowances should remain continuously available in the market. Any allowances that are not sold in an auction should be rolled over to and offered for sale in the next auction. The laws of supply and demand will ensure that the auctions produce allowances prices that reflect their market value, as well as changes in that value over time.¹⁵ Moreover, and for the reasons

¹⁵ This recommendation would also encompass changes arising from unforeseen events. For example, if one or more nuclear facilities or one of the New York Power Authority's large hydroelectric facilities experiences an extended outage, there would be an increased, unanticipated need for replacement power from the fossil-fueled generating facilities (the other nuclear and hydroelectric facilities typically run at full capacity and could not satisfy the shortfall). This would, in turn, increase the demand for allowances and have a concomitant effect on their value and price. If withheld allowances are banked, however, the demand could quickly exceed the supply that has not been withheld, thereby resulting in a run up of prices to the trigger point.

discussed above in Section 2, the absence of artificial and subjective influences on supply and price will provide the proper signals to generators to reduce their emissions and avoid the disincentives that generators would otherwise incur.

6. Withholding Of Allowances By The RGGI States Could Hinder The Development Of A Robust Secondary Market

The Final Report makes frequent references to a secondary market for CO₂ allowances. While the Report does not specify when the secondary market will develop, Professor Shobe stated during the Stakeholder meeting that he believes allowance trading will occur in the secondary market before the first auction occurs. The Final Report states “that a significant amount of allowances will be traded outside of the auctions themselves.”¹⁶ One of the primary underpinnings of the recommended auction design, therefore, is the relationship between the auctions and the secondary market and the efficiencies produced by the interplay between the two.¹⁷

The secondary market trading will be based on the expected cost of trying to comply with the cap and trade levels that have been set by RGGI. If allowances are going to be artificially withheld from the market, thereby effectively enforcing the equivalent of a lower cap and trade level, the secondary market will not be able to function properly because the collective market participants will not know what cap they are trying to achieve.

Moreover, the presence of a contingency bank is not an appropriate response to the potential exercise of hoarding or market manipulation because all it does is limit the potential impact rather than address the root cause of the problem. It fails as a remedy because all the manipulating party would need to do is be willing to release its allowances into the market just

¹⁶ Final Report, p. 11.

¹⁷ See, e.g., Final Report, p. 54.

below the threshold with no risk of additional allowances being injected in the market to reduce that price. As long as the need for allowances exceeds the total amount available, the occurrence of future quarterly auctions would not alter this outcome (and the clearing prices in the future auctions would likely exceed the value of allowances due to the artificial shortage created by the banking).

For these reasons, the RGGI program is not directly comparable to the SO₂ and NO_x auctions discussed in Section 8.2 of the Final Report, where allowances were allocated directly to generators and the supply of allowances, over time, exceeded the demand for them due, in part, to the fact that entities responded to the market signals and installed available control technology on their facilities. Rather, this potential outcome provides another reason why unsold allowances should not be placed in a contingency bank. It also supports the need for strict monitoring of the auctions and of the auction participants' bidding behavior, as well as symmetrical price protections, as explained below.

7. There Is A Need For A Known, Reasonable, Real-Time Circuit Breaker In Addition To The MOU's Safety Valve

The Final Report devotes an entire section to concerns with price volatility. The Northeast Suppliers fully support an effort to mitigate the volatility in allowance prices, even though they disagree with the need for a reserve price to do so. However, the analysis regarding price volatility and the proposed solution addresses only half of the concern and does not provide comprehensive protection.

The concerns about market manipulation and “the possibility of weak competition among asymmetric bidders” apply equally to the potential for allowance prices to increase well beyond

forecast levels.¹⁸ As noted by the IETA, these concerns and others related to the structure of the program and scope of the auctions demonstrate the need for a known, reasonable, real-time circuit breaker mechanism that limits the upside volatility of the allowance prices, especially at the beginning of the RGGI program.

The data available on the RGGI web site, as summarized in the Northeast Suppliers' comments on the Phase I Interim Report, demonstrate that for most RGGI States, the ratio of the generators' emissions to the base budget amounts is very high (above 95% on average). The New York Independent System Operator's ("NYISO") analysis of more recent data demonstrates that while the generators' emissions are going down, the generators will still need the vast majority of the available allowances to offset their emissions.¹⁹ The NYISO concludes that for 2010, the "... restrict[ion] of a liquid supply of allowances to New York generators below 52 million tons may lead to an unacceptable LOLE levels [sic] that violate reliability requirements."²⁰ This level is based on the existing complement of generation plus known retirements and additions. According to the NYISO's analysis, "the loss of a major nuclear unit would translate into a need for an additional 10 million tons per year of CO₂ allowances. [footnote omitted]"²¹

It is widely expected, and acknowledged in both the Final Report and the rulemaking proceedings occurring in a number of the RGGI States, that many entities other than generators

¹⁸ Final Report, p. 56.

¹⁹ The NYISO's 2008 Reliability Needs Assessment ("RNA") indicates that in 2006, emissions from RGGI-affected generators operating in New York totaled approximately 56 million tons. *See* [http://www.nyiso.com/public/committees/documents.jsp?com=mc&directory=2007-11-14/mc_agenda_04_RNA_5th_Draft_110707\[1\].pdf](http://www.nyiso.com/public/committees/documents.jsp?com=mc&directory=2007-11-14/mc_agenda_04_RNA_5th_Draft_110707[1].pdf), p. 25.

²⁰ NYISO 2008 RNA, p. 26.

²¹ *Id.* It is important to note that climatological conditions, fuel prices, the operating levels of certain large, non fossil-fueled units, and other factors individually and collectively affect emissions levels and could cause emissions in any year to deviate, perhaps significantly, from the forecasted levels.

will purchase or otherwise acquire CO₂ allowances. Unlike SO₂ and NO_x emissions, CO₂ emissions cannot be reduced via back-end processes or other technical means at this time. Thus, the demand for CO₂ allowances is likely to remain very high for the foreseeable future.²² Given all of these factors, the Research Team's conclusion that competition for allowances, or at least the allowances that will be available to the generators to offset their CO₂ emissions, could be "weak" is suspect and warrants further consideration.

In contrast, these factors demonstrate that the opposite result is possible. That is, the competition for allowances in comparison to the number of allowances available could cause auction prices to rise substantially. Further, because the design and one intent of the RGGI program is to create a revenue source for energy efficiency programs, promotion of renewable energy, and other purposes, it is plausible that some market participants may want to place upward pressure on auction prices. In this regard, the RGGI program is very different from all other emissions programs, where the majority of the allowances are given to generators, a small portion are sold at auction, and the auction proceeds are used to fund or provide incentives for investments by the generators in emissions control technologies. Because other entities cannot directly benefit from the auction revenues in those programs, they have no incentive or interest, as they do here, to maximize auction clearing prices. Finally, market participants whose sole interest is to earn profits by trading allowances may also want to place upward pressure on auction prices (at a minimum, such participants will presumably want price volatility in order to maximize their profits).

²² At present, maximizing the efficiency of operations or reducing operations altogether will eliminate CO₂ emissions. Given the fact that merchant generators must rely on market revenues to support their operations, the efficiency of their operations is likely to have already been maximized. Fuel switching also can reduce emissions, but a number of power plants in the RGGI States are incapable of switching fuel sources. Also, over-reliance on natural gas and the concomitant reduction in fuel diversity creates a number of deleterious effects, including a reduction in system reliability and an increase in energy price volatility.

The generators are, to a large extent, captive to whatever clearing prices the auctions and secondary market produce. As the allowance prices increase, it is reasonable to assume (as studies by the NYISO and other Independent System Operators/Regional Transmission Organizations (“ISOs/RTOs”) have begun to do) that the generators will be required to, within applicable market rule constraints, correspondingly increase the bids they submit for their output. As a result, consumers will be forced to bear unnecessary and avoidable increases in their electricity bills.

To protect against these potential price increases, and in lieu of the contingency banking discussed above, the Stakeholder Process should develop a known, reasonable, real-time circuit breaker. While the safety value mechanism set forth in the MOU may help prevent long term threats to the viability of the RGGI program and the reliability of the electric system, it cannot prevent or counteract short term behavior or circumstances that could pose the same threats. Accordingly, the auctions should be designed with a circuit breaker mechanism that protects against undue influences on and prevents excessive increases in the auction clearing price. Consistent with Governor Spitzer’s recent statements to Congress regarding the financial and economic implications of the RGGI program (*i.e.*, that the costs of the program will be “modest” with “low” cost impacts for consumers),²³ the circuit breaker should be based on ICF’s economic analysis and forecast of allowance prices.

Regardless of how and at what price the circuit breaker mechanism is set, care must be taken so that the mechanism does not inadvertently create an above-market allowance price. Among the options available to protect against secondary market allowance sellers from simply raising their asking price to the circuit breaker level is ensuring that the number of available

²³ Governor Spitzer’s Congressional Testimony, dated November 14, 2007, p. 3.

allowances exceeds the demand (*i.e.*, no contingency banking of unsold allowances). Another option is limiting the number of allowances that any single entity can own or control, as discussed below, so that they are not pivotal players and cannot influence or increase the clearing prices by hoarding either unilaterally or through collusion. A third option would be to prevent allowances from being directly retired and eliminated from use as emissions offsets.

8. The Final Report Analysis Does Not Properly Assess The Potential For And Risks Of Hoarding; A Two-Stage Auction Design Should Be Adopted To Minimize Its Attendant Risks

The Final Report identifies five possible types of hoarding, discusses each of the types, and then concludes that a combination of monitoring and tracking allowance ownership will provide adequate safeguards for the RGGI program. To further protect against hoarding, the Research Team suggests that auction participation be limited such that no single entity can purchase more than one-third of the allowances available in any auction. The Northeast Suppliers respectfully submit that the Final Report does not properly analyze this issue, and relying on an approach for an incomparable product is misplaced.

The analysis reflected in the Final Report appears to be premised on the potential actions of one entity. It is perhaps accurate to assert that if one entity acquires a substantial quantity of emissions, especially an entity that is not a fossil-fueled generator, its activities would be subject to scrutiny. However, under both the recommendations in the Final Report and the proposed regulations, the only impediment or restriction to such an acquisition is overly broad, and there is not a clearly defined mechanism for detecting such behavior in a timely way.

More importantly, though, the Final Report does not analyze the potential for a number of entities that are not fossil-fueled generators from acquiring relatively significant numbers of allowances (*e.g.*, between 1% and 5% of the available allowances). As explained above and in

the Northeast Suppliers' previous submissions to the Staff Working Group, the generators operating in the RGGI States will need, under the most optimistic projection for CO₂ reductions, at least 80% of the available allowances to offset their emissions. If three entities were each to acquire and withhold 10% of the available allowances, the impact on the value of the allowances would be dramatic. Each entity could then sell a small portion of its allowances at prices that could result in an overall net profit (*i.e.*, the sale price could exceed the cost of acquiring all of the allowances). If those entities made similar acquisitions each year, the consequences could be calamitous. The Northeast Suppliers therefore submit that appropriate safeguards be assessed and implemented now, not in the future after such behavior has occurred, as proposed in the Final Report.²⁴

As one proposed protection against hoarding, the Research Team looked to the rules employed by the federal government in U.S. Treasury auctions. The Northeast Suppliers submit that Treasury auctions are in no way comparable to CO₂ allowance auctions. The allowance market is likely to have very low short-term price elasticity, whereas U.S. Treasury securities have very high price elasticity. Further, unlike U.S. Treasury securities which have a wide range of near perfect substitutes, RGGI CO₂ allowances are a single purpose product with no substitutes except a very limited ability to rely on offsets. Most of the available allowances each year will be required to offset plant emissions. Because the total universe of CO₂ allowances does not continually expand, in contrast to U.S. Treasury securities, the use of the same one-third acquisition limit per auction will not adequately address the concerns regarding the potential for the development of a pivotal allowance holder that finds it economically rewarding to artificially cause a shortage in allowances that are needed by generators to offset their CO₂ emissions. To

²⁴ See Final Report, p. 75.

take the extreme example, if one entity acquires the maximum one-third share in each auction, it would acquire enough allowances in three auctions to be able to considerably drive the price of allowances in subsequent auctions and the secondary markets. For these reasons, speculators should not be allowed the same freedom to purchase and hold in the allowance market that they are allowed in the U.S. Treasury securities auctions.

The Northeast Suppliers recommend, therefore, that the RGGI States impose tighter limits on the number of allowances any entity could own or control to ensure that no entity can obtain a pivotal position and improperly influence the market clearing price or adversely affect the reliability of the electric system by preventing generators from obtaining the allowances they need to offset their emissions.²⁵ One possible approach to doing so would be to create a two-stage auction in which the generators are able to obtain sufficient allowances to offset their CO₂ emissions and reliably operate their facilities, while at the same time preserving the design recommendation in the Final Report that the auctions be open to all interested participants

Phase 1 would be open only to generators with RGGI-affected facilities. The total number of allowances made available would be limited to the generators' collective pro-rata share of the allowances needed to meet their minimum reliability needs. The determination of the minimum reliability needs for the RGGI program should be consistent with the determination applicable to the wholesale electric markets to avoid conflicting standards and to ensure that both markets provide for safe and adequate levels of generation to serve the citizens of the RGGI States.

²⁵ For purposes of this recommendation, the limitation should apply collectively to companies, partnerships, and other business arrangements under common ownership or control and to the individuals possessing that ownership or control. Also, the recommendation is premised on a regional auction with fully fungible allowances that are continuously offered for sale (*i.e.*, none are placed in a contingency bank). Individual auctions or restricted allowances would require modifications to the proposed approach.

Each generator would be prohibited from purchasing more than its individual pro-rata share of the minimum need. Its pro-rata share could be determined based on the higher of its maximum annual emissions rate over the past five years or its maximum actual emissions rate over the immediately preceding quarter pro-rated up to an annual equivalent. The reason for this approach is to address the possibility of newly changed circumstances that substantially alter the prospective operation of one or more generating facilities (*e.g.*, an outage at a nuclear generating facility).²⁶

Phase 2 of each auction would include any allowances not sold in phase 1 plus the balance of the allowances allocated to that auction plus any unsold allowances from the previous auction. Phase 2 would be open to all interested participants. To avoid the potential for hoarding, a limit should be imposed on the total number of allowances any entity could acquire in any phase 2 auction. For the reasons discussed above, the limit should be below the 33% threshold discussed in the Final Report. The Northeast Suppliers have not yet had sufficient time since the release of the Final Report to fully evaluate and make any specific recommendations on an appropriate limit. This is a very complicated issue and many factors must be balanced in establishing the limit. The Northeast Suppliers will continue considering this issue and would welcome the opportunity to work with the Staff Working Group, Research Team, and other stakeholders to jointly develop and evaluate an appropriate limit.

Generally, the limit should be set at a level that fosters the competitive nature of the auctions and of the secondary market while prevented any single market participant from being able to dominate the auction or acquire a pivotal position. Such an approach is consistent with the opening statement of the MOU that the safe and reliable electric system be maintained. It

²⁶ Within this general structure, an exception would need to be created for contemporaneous unanticipated circumstances that cause forecasted needs to deviate from historical, including recent, needs.

also minimizes the potential for market manipulation that results from the very low price elasticity of demand by generators for the allowances.

9. Further Development Of Market Monitoring Measures Is Needed

An essential element of the design of the RGGI program, in general, and the allowance auctions, in particular, is the nature of the monitoring that will be undertaken.²⁷ As the Report notes, collusion (tacit or otherwise) may become a problem over time and the RGGI States should “be prepared to make adjustments to the auction design if such collusive behavior becomes evident.”²⁸ However, the Final Report offers few details regarding the type and extent of monitoring that should be undertaken. Instead, it offers only a few high level suggestions and the recommendation that there should be coordination with the Federal Energy Regulatory Commission and the ISOs/RTOs. Coordinating the monitoring of the RGGI program with the monitoring of the wholesale electric markets makes sense, generally, but details are needed as to how that coordination should occur, as well as the authority the monitoring agency(ies) should be given. Additionally, the independence of the persons or entities performing the market monitoring functions should be explicitly reflected in the governing regulations and program rules.

More broadly, and an issue not addressed in the Final Report, is the need for monitoring of the overall RGGI market, including the secondary market to protect against the potential of pivotal players in the market. As explained in the Final Report and the Stakeholder meeting, the

²⁷ The Northeast Suppliers respectfully disagree with the observation in the Final Report (p. 43) “that market monitoring is not an auction design issue *per se*.” For the reasons set forth below, as well as those discussed in Section 5.4 of the Final Report, the ability to monitor and the extent of the monitoring needed are functions of the auction design.

²⁸ Final Report, p. 45.

clearing price developed in the secondary market is intended to dictate, to a large extent, the auction clearing price. No one, except the potential market manipulator, benefits if the secondary market price is run up as a result of market manipulation by one or more pivotal players and the auction price accurately follows it. Therefore, solely monitoring the auctions may not be sufficient to detect manipulative or other inappropriate behavior that has already occurred in the secondary market.²⁹

It is critical that clear and specific standards be developed and given the force of law by inclusion in the formal RGGI regulations. These standards should specify the acceptable levels of allowance ownership to avoid pivotal players and acceptable types of behavior that constitute market manipulation or is otherwise improper. Similar standards already exist in the wholesale electricity markets, and they should be used as a starting point or guidance for this program.³⁰

Establishing clear and binding standards puts all market participants on notice as to acceptable and unacceptable conduct, as well as the consequences for violations. They provide objective tools against which specific conduct can be assessed and reduce the potential for allegations that different rules are being applied to different entities.

If clear standards are not adopted and formalized, the analysis of an entity's behavior will be subjective and open to criticism and attack. Also, and best demonstrated by the California Energy Crisis, the absence of specific standards could allow manipulative behavior to continue for an extended period (up to a year or possibly longer) before being identified and addressed. Regulators and other auction overseers are naturally hesitant to accuse a market participant of

²⁹ As a corollary to this point, there is a need to periodically monitor the market participants' use of the allowances they acquire. If retirements are prohibited, as the Northeast Suppliers recommend, market participants should not be permitted to sidestep this prohibition by simply acquiring and holding allowances indefinitely. The market monitor should therefore periodically evaluate the duration of time allowances are being held and the reasons why market participants are holding allowances for extended periods.

³⁰ See, e.g., the New York Independent System Operator's Market Administration and Control Area Services Tariff, Attachment H.

manipulation unless it is amply demonstrated, confirmed, and well-documented. Comparing specific behavior to objective standards provides a relatively expeditious means of demonstrating, confirming, and documenting the assertion.

Furthermore, the independence of the market monitor is imperative to establishing and maintaining the credibility of the RGGI program. To minimize regulatory uncertainty and its attendant risks, and to ensure equal treatment of all market participants, the persons or entities conducting the market monitoring should have no stake in the outcome of the auctions or secondary market. They should not be directly answerable to any entity that has a stake in the program. Inasmuch as one facet of the program is to produce revenues for the RGGI States, the States arguably have a stake in the outcome. Therefore, the market monitor should be separate and independent from the state agencies involved with the program.³¹

Turning to the Research Team's specific recommendations, disclosure of beneficial ownership is a reasonable requirement, but it must be tied to specific and severe consequences to ensure compliance (*e.g.*, forfeiture of allowances improperly obtained or prohibition against participation in future auctions or the secondary market). Details are also needed as to how this information will be used for monitoring purposes and to screen for attempts by one or more market participants to manipulate auction and/or market clearing prices or to engage in hoarding or other inappropriate conduct. Similarly, while the suggestions for a "Statement of Intent" and annual reporting requirements have some merit, the lack of consequences for violating the Statement and the potentially permissive nature of the reporting requirements render them

³¹ For the same reasons, if the RGGI States ultimately decide to impose a reserve price, the independent market monitor should be the entity assigned the task of setting that price.

useless from a monitoring perspective. It is wholly inadequate to simply rely on market participants' attestations without any verification.³²

While the Northeast Suppliers support the proposition set forth in the Final Report that costs and burdens are important factors to consider in developing a monitoring program, they respectfully submit that the potential impact of the lack of meaningful oversight substantially outweighs the burdens and costs of a comprehensive program. Accordingly, the Research Team or the Stakeholder Process (or both) should be directed to develop specific, detailed recommendations as to: (i) the type of monitoring that would be most appropriate for a sealed bid, uniform price auction format; (ii) consequences for failure to comply with any monitoring requirement; and (iii) how and under what circumstances the uniform price format should be changed in the event the monitoring reveals inappropriate or otherwise detrimental, unanticipated behavior.

To facilitate the monitoring of the market in general, one possibility would be to require all allowance trades to be recorded on a common database.³³ The total holdings of every entity should be similarly tracked and monitored. In the event it appears that an entity is acquiring a substantial or pivotal position, further market monitoring activities, such as the application of the standards discussed above, could be triggered.

³² By way of analogy, the New York State Energy Research and Development Authority ("NYSERDA") requires entities providing services under its various energy efficiency programs to periodically report on and certify the nature and extent of their activities. It then sends inspectors in the field to monitor and verify the providers' activities and statements.

³³ The RGGI regulations proposed to date do not contain the same tracking or recordation requirements or even require recordation of all allowance transfers. Also, it bears mentioning that this information should be kept confidential by the program administrators, and the need for confidential treatment should not inhibit or control the nature or amount of information collected.

10. There Should Be One Regional Auction With Fully Fungible Allowances

From its inception, RGGI has been intended to foster a collective response to global warming concerns. Proceeding individually with the auctions and allowance trading programs, therefore, seems to be inconsistent with and counterproductive to the program's construct. To maximize the efficiency of the RGGI program and minimize the administrative burdens and costs, as well as transaction costs, the Northeast Suppliers urge the RGGI States to follow the recommendations in the Final Report regarding a regional auction and fully fungible allowances, to the extent both are consistent with applicable law in each RGGI State.

The proposed regulations issued to date demonstrate that there could be different rules in each RGGI State. Also, none of the proposed regulations or statutory amendments enacted to implement the RGGI program expressly require a regional auction or fully fungible allowances.³⁴ The lack of consistency among the RGGI States and limitations on allowance trading will both hamper the effectiveness and the ability of the generators to cost-effectively and efficiently achieve the goals of the RGGI program.

The two-stage auction approach recommended in Section 8, above, would be fully compatible with this approach. A regional auction would expand the number of available allowances in each auction, as well as the demand for them, resulting in a more robust auction process. The fungible nature of the allowances would increase the opportunities for each generator to acquire a sufficient number of allowances to match its emissions, thereby reducing the risks and uncertainties of the RGGI program and concomitantly keeping the impacts on consumers relatively modest.

³⁴ While some RGGI States enacted statutory amendments to provide legal authority for the RGGI program, other States did not. In those States, it is not clear whether they have sufficient legal authority to participate in a regional auction or issue fully fungible allowances.

It is important to note that these two features are interrelated, and one should not be permitted without the other. IETA explained that in the European Union's Emissions Trading Scheme ("EU ETS") auctions, "over 50% of the auctioned allowances left the auctioning jurisdiction."³⁵ Thus, if the allowances are fully fungible but each RGGI State holds its own auction, the EU ETS experience could occur here with deleterious consequences.³⁶

11. Some Adjustments Should Be Made To The Auction Schedule

The sole concern of the Northeast Suppliers regarding the auction schedule is with the recommendation regarding the schedule of the auctions for each vintage. While the schedule proposed in Table 5.1 was offered for illustrative purposes and could not be adopted exactly as presented, it nevertheless provides a reasonable conceptual approach. In fact, the Northeast Suppliers appreciate the fact that their concerns about planning certainty and coordinating the timing of the allowance auctions with those of the wholesale electric markets were acknowledged and addressed.

As proposed, the latter four auctions for each vintage would occur during the vintage year. For planning purposes and to provide greater certainty regarding prospective electricity production costs, the Northeast Suppliers recommend that those four auctions be advanced by one quarter. That is, the four regular auctions for each vintage should occur beginning in the fourth quarter of the preceding year and continuing in the first three quarters of the vintage year.

³⁵ IETA Comments, p. 3.

³⁶ As explained by the NYISO in its 2008 RNA, the inability of the New York generators to obtain at least 52 million allowances in 2010 would jeopardize the reliability of the electric system for that year. The NYISO qualifies this conclusion by explaining that the actual need will vary each year and is dependent on the factors listed in footnote 21, *supra*.

12. The Financial Assurances Should Be Consistent With Those Already Applicable In the Wholesale Electricity Markets

The Final Report and proposed regulations respectively recommend and require stringent financial assurances to ensure that winning bidders in the allowance auctions are able to satisfy their associated financial obligations. The Northeast Suppliers generally support the need and rationale for such financial assurances. However, the Final Report and at least some of the proposed regulations differ as to the acceptable types of financial security. As clarified by Professor Shobe, the Research Team recommends that the financial assurances could include the use of credit ratings, corporate guarantees, and other non-cash commitments, as well as cash or its equivalent. In contrast, the proposed regulations for the CO₂ Allowance Auction Program in New York allow for only cash and cash-equivalent financial security.

In the formation of the wholesale electricity markets and ISOs/RTOs, many of the same market participants that will participate in the RGGI program grappled with similar financial assurance issues. The Northeast Suppliers recommend that the RGGI States follow the approach set forth in the Final Report and already in place at the three ISOs/RTOs whose control areas include the RGGI States.³⁷

13. Clarification Of Clearing Procedures Is Needed

One important detail that is not discussed in the Final Report or the proposed regulations is the timeline for closing and finalizing each auction and announcing the resulting clearing price. In the event market participants are required to provide cash or cash-equivalents as financial assurances, their funds should not be kept as collateral for extended periods of time after the auctions. In the wholesale electricity markets, auctions are typically finalized in a matter of

³⁷ See, e.g., the New York Independent System Operator's Market Administration and Control Area Services Tariff, Attachment K.

one to three days, after which all collateral that is not needed to satisfy an entity's auction obligations is released. A similar procedure should be employed for the allowance auctions.

Also, it is not clear how long after each auction the clearing price will be announced. If there is a substantial delay in announcing it, the uncertainty could unnecessarily place upward pressure on the secondary market clearing price and potentially on the next auction. To avoid this consequence, the clearing price should be publicly announced simultaneously with the closing of the auction transactions.

14. Market Testing Should Be Employed

In their comments on the Phase I Interim Report, the Northeast Suppliers recommended that the RGGI States conduct market tests of the RGGI program with market participants. They renew this request and recommend that before the auction design and proposed regulations are finalized and adopted, both the proposed design and the market rules be tested under near real-life conditions. Because no other emissions market has included the auction of 100% of the available allowances, reliance on experiences in other emissions markets is not appropriate. It is essential that the market participants gain an understanding of how this market is to operate before they are required to commit millions of dollars to it.

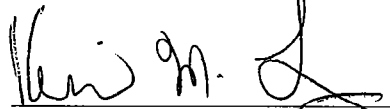
In an analogous situation, the ISOs/RTOs conducted similar tests before they commenced the implementation of major software design changes. In addition to providing an understanding of how the markets were supposed to work, those tests were very useful in identifying issues and problems and developing solutions prior to the time that such software was implemented. Inasmuch as the first auctions are not anticipated to be held until the middle of 2008, there is enough time to conduct a series of market tests, evaluate the performance of the market and

market rules, identify formerly unanticipated problems, and modify or clarify the rules and auction design structure, as appropriate.

Thank you again for the opportunity to submit these comments. The Northeast Suppliers would welcome the opportunity to meet with the Research Team and Staff Working Group to answer any questions they may have regarding the foregoing or to assist them in further developing and refining the auction design and other aspects of the RGGI program.

Dated: November 15, 2007
Albany, New York

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Kevin M. Lang", written over a horizontal line.

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