



**FPL Energy**

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## **Comments of FPL Energy, LLC to the Phase 2 CO<sub>2</sub> Allowance Auction Design Final Report for the Regional Greenhouse Gas Initiative**

FPL Energy, LLC (“FPLE”) is pleased to submit its comments on the recommendations contained in the Final Report of the Research Team commissioned by the Regional Greenhouse Gas Initiative (“RGGI”) states for the design of an auction of CO<sub>2</sub> allowances. This Final Report, entitled “Auction Design for Selling CO<sub>2</sub> Emission Allowances Under the Regional Greenhouse Gas Initiative,” is an important milestone in the effort to implement a regional program to reduce greenhouse gas emissions. FPLE commends both the research team and the RGGI states for their continued leadership role in confronting this critical problem.

By way of background, FPL Energy is one of the largest and cleanest power generating companies in the nation with operations in 25 states. We are the largest generator of wind power in the country and operate the largest solar facility in the world in California. We are the largest producer of hydroelectric power in Maine and own and operate three nuclear generating facilities in the United States. We also have a number of fossil-fired generation assets within the RGGI region that will be subject to the RGGI program.

FPL Group, our parent company, has been a corporate leader on the critical issue of reducing greenhouse gas emissions. We have participated in the U.S. Department of Energy’s Voluntary Reporting of Greenhouse Gas Emissions 1605(b) program since 1995. Our most recent report documents a 28% reduction in our greenhouse gas intensity over 1990 levels through efficiency gains, repowering to lower carbon-emitting fuels and increasing our portfolio with new non- and low-emitting generating. FPL Group is a charter member of the U.S. Environmental Protection Agency’s Climate Leaders Program. Additionally, FPL Group is one of fourteen original signatories of the U.S. Climate Action Partnership (USCAP), an alliance of diverse organizations such as BP America, General Electric, Environmental Defense, the Pew Center on Global Climate Change and the World Resources Institute. This alliance has called on the federal government to quickly enact strong national legislation to achieve significant reductions of greenhouse gas emissions.

On a regional level, FPLE has participated in the development of the Regional Greenhouse Gas Initiative since its inception.<sup>1</sup> As it relates to auction design, structure and

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<sup>1</sup> FPL Energy participates in a variety of trade organizations that represent generators and suppliers in the various RGGI states. Included among those organizations are the New England Power Generators Association (NEPGA), the Independent Power Producers of New York (IPPNY), the Independent Energy Producers of New

implementation, FPL Energy has considerable experience through participation in hundreds of auctions, including energy, ancillary service, transmission rights and capacity markets in the various ISOs and RTOs throughout the country; multiple state- and utility-sponsored full requirements auctions; as well as environmental auctions. As such, we adhere to the following basic principles of auction design:

- Transparency of Rules and Information – More information is better than less in designing and implementing successful auctions.
  - Full knowledge and disclosure encourages participation.
  - Full knowledge and disclosure discourages collusion and manipulation.
- Simplicity, Familiarity and Ease of Design, Use and Implementation produce the most efficient, effective auctions.
- Efficiency – Allowances should be obtainable by those who value them most.

With this in mind, our comments on the Phase 2 research and recommendations are as follows:

**Phase 2 Recommendations** – In the Phase 2 Report, the researchers recommended the following:

1. **Auction Format - The RGGI auction should use a single-round, sealed-bid, uniform-price auction format, with the auction clearing price being the value of the highest rejected bid.**

FPLE supports the report's recommendation for this auction format. It is familiar to many market participants, easy to understand and administer, and represents the type of simplicity of design that produces efficient, effective results. In our experience, as well as through discussions with auction experts, the recurring theme was that successful auctions start with a basic, readily understood design. Consistent with this, we support the use of the recommended auction format throughout, rather than modifying or changing formats in future auctions. Our concern, expressed in previous comments, was that the initial Phase 1 recommendation was for the implementation of an English Clock auction paired with a shotgun or "shootout" round at the end. This additional layer of complexity, relatively unusual in either electricity or environmental auctions, can result in a level of confusion and risk

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Jersey (IEPNJ) and the Independent Energy Producers of Maine (IEPM). While some of the positions represented by these trade organizations on RGGI and the Phase 2 report may be similar to those held by FPL Energy, others are significantly different. The views of those organizations should not be considered representative of those of FPL Energy. The comments submitted herein represent solely those views of FPL Energy.

aversion that produces inefficient market outcomes.

**2. Separate auctions should be held for different vintages.**

FPLE concurs with this recommendation. The Phase 2 report noted that the potential for adding a fourth year to the compliance period, in the event of a Stage 2 event, necessitated this requirement. This approach is reasonable.

**3. Frequency – The auctions should be held quarterly.**

According to the report, a primary auction design criteria is to ensure that the auction aligns well with wholesale energy and capacity markets. FPLE understands the expressed desire of the researchers to balance the need for auction frequency with the need to develop a competitive secondary/spot market. In New York, capacity auctions occur on a monthly basis. Given that CO<sub>2</sub> allowances are a critical input in the cost of operating fossil-fueled generation, FPLE recommends monthly auctions. More frequent auctions ensure that allowances are available with a level of frequency that allows participants to adjust as market prices change. While we are less comfortable with the recommendation of quarterly auctions, for the reasons noted above, it should be considered the minimum level of frequency.

**4. Future allowances should be made available four years in advance of their vintage.**

FPLE agrees with the report's recommendation. As was discussed by the researchers during the November 7<sup>th</sup> Stakeholder Session, the goal in making allowances available in advance of their vintage was to balance the importance of allowing fossil-fueled generation to plan and procure far enough in advance, while not procuring so far in advance so as to risk having RGGI conflict with, or superseded by, a federal carbon reduction program. Releasing future year allowances up to four years in advance reasonably achieves that balance, and helps reduce compliance uncertainty for generators.

**5. Reserve Price – A reserve price should be used at each auction. In general, the reserve price should be announced publicly, with the possible exception of the first auction.**

One of the stated criteria for selection of an auction type is price discovery. The use of a reserve price impedes true price discovery in that it creates an artificial floor price. While FPLE does not suggest the use of a reserve price, we understand the researchers believe it to be a critical component of successful auction design. If a reserve price is used, it must be transparent (another key auction design criteria) and known sufficiently well in advance of each auction. We do not believe an undisclosed or unannounced reserve price should be used for the first auction or any auction.

Beyond that, the methodology used to establish the reserve price – whether for the initial auction or subsequent auctions – must be better disclosed, detailed and vetted with stakeholders. While the Phase 2 report is somewhat vague on the procedure used to set a reserve price, the discussion at the November 7<sup>th</sup> Stakeholder Session on how it would be set was even less encouraging. In describing how the initial reserve price might be set, the researchers noted that one option or price point would be based on activity and pricing in the pre-auction secondary market. While perhaps we may have misunderstood this point, we do know that in a market in which all allowances are distributed through the auction, there is no credible secondary market prior to the initial auction. Only those who are taking speculative positions – and they may or may not be credible participants – would be involved in establishing that pre-auction market, and any gleaning of such a price point to use as an initial reserve price provides significant cause for concern.

Again, since the reserve price impedes true market price discovery, a effective method for establishing that reserve price is critical. Given the particular concern regarding the establishment of the initial reserve price, FPLE recommends that it be set at \$0.

**6. Unsold Allowances – Two options have been identified for allowances unsold because of insufficient demand or because the reserve price is triggered.**

**Option 1 – Roll unsold allowances into a contingency reserve account and don't release for sale until some RGGI auction closes above a specified value;**

**Option 2 – Some or all of the unsold allowances could be rolled into the next auction.**

In our earlier comments, we reiterated a key criterion for the selection of a successful auction type – price discovery. As has been stated by the researchers, “Accurate price discovery in an auction can help identify a market price close to the marginal cost of reducing emissions.” With that in mind, we strongly urge that unsold allowances be sold in the next auction. There are several reasons why a generator might not choose to purchase allowances in a given auction, reasons unrelated to the lack of demand. Included among them are seasonal weather changes, which result in lower-than-expected generation and allowance requirements. Additionally, fuel price fluctuations could result in fuel-switching and reduced allowance requirements and procurement.

The option to place unsold allowances into a contingency bank directly interferes with market pricing, exactly what successful markets should avoid. While perhaps the “release” point from the contingency bank is objective, such as a Stage 1 or Stage 2 event, the contingency bank option withholds allowances to a certain price level and then releases them back into the market, creating a level of uncertainty and

market volatility. During the November 7<sup>th</sup> Stakeholder Session, the researchers noted that one benefit of utilizing a Contingency Bank was to influence the moderation of market pricing, since market participants would know in advance that prices couldn't drift too high without a release of additional allowances. This level of manipulation is troubling and should be avoided. If the researchers are concerned that the rollover of allowances into subsequent auctions could result in extremely low market pricing, the reserve price will never allow that to happen, resulting in price support at a predetermined level.

**7. Minimum Lot Size - Lot size at auction should be a minimum of 1,000 allowances.**

FPLE agrees with this minimum standard for the regional auction. Smaller quantities such as those that might be purchased by interested individuals would still be available in the secondary market.

**8. Participation and Purchase Limit – Auctions should be open to anyone willing and able to meet financial prequalification, but no single entity should be able to purchase (or take a beneficial interest in) more than 33% of the allowances for sale in any auction.**

FPLE supports limiting participation in the auction to those entities that are actually regulated by RGGI. RGGI was established to reduce greenhouse gas emissions from the electricity sector utilizing a regional auction as a method of distributing allowances for electric fossil-fueled generators to comply with reduction goals. As such, FPLE urges the participation in the auction to be limited to those entities that are required to use the allowances for compliance. The regional auction will have sufficient numbers of affected generators on a region-wide basis to provide a robust auction environment and will certainly lead to the stated goal of the researchers that “bidders who have the highest value for a RGGI CO<sub>2</sub> emission allowance obtaining that allowance.” Clearly a generator needing to purchase allowances in order to produce its product will place a high value on this compliance component. All other interested, qualified market participants should be able to participate in the secondary market.

As indicated in the Phase 2 report, price differences between the auction and the secondary market will equalize. Because of this equalization, entities that are not regulated by the RGGI program but wish to participate in the trading market will not be harmed by trading in the secondary market. The key auction design criteria of “fairness and transparency” will still be maintained without potentially harming those generating entities that need allowances for compliance.

Again, RGGI is a program designed to regulate certain electric generators, in this case those that emit CO<sub>2</sub>. The ability of these units to operate reliably in support of the grid and the consuming public will depend on the ability of these regulated units

to acquire allowances. In an open auction environment – when the regulated and unregulated alike can participate in such an environment – the risk of hoarding remains, particularly at the outset of a market in which 100 percent of the allowances will be distributed via auction. We appreciate the effort of the researchers to assuage the concerns of the regulated community that hoarding behavior is unlikely, whether due to the frequency of the auctions, limits on procurement in each auction by individual entities, or the possibility of limiting future auctions in the event that allowances become scarce. Still, our concerns about hoarding remain.

In its most recent Reliability Needs Assessment, the New York Independent System Operator (NYISO) highlighted a similar concern, noting that a risk to reliability could occur if a minimum number of allowances – 52 million allowances out of 64 million allowances in the Year 2010 -- wasn't available to generators serving the New York Control Area.

Of course, hoarding can also occur among regulated entities as well, in which case some restrictions may be reasonable in terms of the amount of allowances that a generator may purchase during a single auction. For example, the limit for a single auction held quarterly would be 50 percent of its projected annual need based on historical emissions.

**9. Accepted bids should be treated as binding contracts, and bidders must provide strong financial assurance to cover the value of any bids.**

FPLE concurs with this recommendation. In addition, we urge strong penalties up to and including prohibition from future auctions if a bidder fails to honor a contract. Such a severe penalty for a generator in need of compliance allowances would certainly deter any unwanted or inappropriate behavior. Should non-regulated entities be allowed to participate in the auction, no longer being able to participate in a desirable commodity market would also be a deterrent.

**10. There should be a joint and uniform auction for allowances of a given vintage sold from all RGGI states.**

Central to the purpose of having a regional greenhouse gas reduction program is having a trading platform that includes as large a pool of allowances as possible to maximize compliance flexibility at the lowest cost for consumers. Single state auctions, or auctions whose products (allowances) are not equivalent in value, unnecessarily complicate the trading mechanism and are administratively cumbersome for both the bidder and the auction administrator. It is imperative that a joint regional auction be established to sell allowances that are identical in value for a particular vintage regardless of the state of origin.

11. **Market Monitoring – RGGI market monitoring efforts should take advantage of existing monitoring activities by federal and state agencies and other interested parties.** Specifically, the report indicates that RGGI should coordinate with the Federal Energy Regulatory Commission (FERC), the U.S. Environmental Protection Agency (EPA), the Independent System Operators (ISOs), and the Commodity Futures Trading Commission (CFTC) in designing criteria for detecting market manipulation and for sharing of information regarding the performance of the allowance market and the detection of attempts to manipulate prices.

FPLE supports this recommendation, and encourages the researchers and the RGGI states to review the market monitoring and compliance mechanisms in place in the various markets throughout the U.S. and internationally. Clearly, strong market monitoring is vital to any market based platform and is critical to ensure a robust market that is free of manipulation. One model that the researchers and RGGI states might consider is one used today by the New York Independent System Operator (NYISO) and ISO-New England (ISO-NE). Both employ an internal market monitoring unit to ensure real-time, day-to-day implementation of market rules and determine whether any anomalous behavior is taking place. Additionally, both employ an Independent Market Advisor (IMA), whose responsibility is to review the auction results and performance of the market as a whole and determine whether the performance and outcomes are competitive. If not, the IMA recommends to the ISOs and stakeholders the necessary modifications in the rules or market structures to correct any deficiencies. In our estimation, it is a model that has worked well in the NYISO and ISO-NE, and may be fairly easily adapted for RGGI.

12. **Disclosure of Beneficial Ownership – RGGI should require that the authorized account representatives be obliged to disclose the “beneficial ownership” of any allowance holdings.**

FPLE agrees with this recommendation.

13. **Disclosure of Auction Information – Information from the auction that should be publicly disclosed includes the auction clearing price, the identities of winning bidders and the quantity of allowances obtained by each winning bidder.**

The researchers have noted that the primary goal of disclosing certain data to the market is to ensure that participants have that information which is essential to well-functioning, transparent, competitive markets. While FPLE agrees that the auction clearing price and the quantity of allowances sold at that price represent critical information which should be publicly disclosed without delay, we see significantly less value in publicly revealing the identities of winning bidders. That information should be obtained with the bid documents and readily available to RGGI staff and the entity implementing the auction, but held as confidential. We are concerned that such disclosure could inappropriately influence not only the auction itself, but price

formation in the secondary market.

14. **Statement of Intent – RGGI should articulate the auction goals in a “Statement of Intent” and ask all participants in the auction to acknowledge that statement and agree not to undermine these goals.**

FPLE understands the researchers’ desire to not unduly add risk to participants by requiring a contractual obligation to take some type of “good faith” oath, but by making a statement in a non-binding agreement with no penalty for violating the agreement raises the question of the value of such a statement.

15. **Auction Performance Evaluation – RGGI should evaluate the performance of the auction on an ongoing basis as part of their administrative oversight of the program.**

We agree with this recommendation; this is consistent with our comments on Market Monitoring in Item 10.

### **Additional Items**

FPLE would like to raise two additional points, beyond those raised in the Phase 2 report:

1. **Market Trials** – Among other techniques and sources of information, we note that the researchers used undergraduate students to simulate various market conditions and outcomes in helping develop an effective, efficient market design. FPLE recognizes and strongly supports the goals of RGGI, reducing harmful CO<sub>2</sub> emissions; and while we do so we also note the criticality of reliable electricity supply to the public. The provision of this supply and the competitive markets that have evolved around it are extremely complex; while the lab methods employed by the researchers may be quite valid in simulating auctions, they may not capture all of the thought processes and considerations associated with those individuals and entities purchasing, selling and producing electricity every day. For this reason, we strongly encourage the researchers to develop a program of auction/market trials involving actual electricity market participants. FPLE would be pleased to assist the researchers and the RGGI states in crafting such a program, or providing additional information in support of such a program.
2. **Utilization of Metric Tonnes** – As presently designed, the RGGI MOU and Model Rule equate allowances to “short tons.” While the United States has historically used short tons for measurement, in the broader international marketplace, CO<sub>2</sub> allowances are traded in metric tonnes. FPLE encourages the RGGI organization to evaluate whether it should continue to utilize short tons or convert to metric tonnes. We would note that the Chicago Climate Exchange, North America’s only and the world’s first global emissions marketplace, employs metric tonnes as its measurement



methodology. We all recognize that reducing greenhouse gases is a global challenge; we also recognize that over time, regional and national CO2 reduction programs will move beyond our immediate geographic boundaries, and transitioning to an internationally-recognized metric may be beneficial sooner than later.

In conclusion, FPLE sincerely appreciates the work done by the University of Virginia, Resources for the Future, the California Institute of Technology and the sponsoring RGGI states and agencies in developing these auction design recommendations. In the absence of a national program, we support RGGI's efforts to establish a regional auction. FPLE looks forward to continuing our participation in the RGGI process and would be pleased to respond to any questions you might have now or in the future.

Sincerely,

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November 15, 2007