

**Comments of New York State Attorney General Eliot Spitzer  
on the  
Draft Model Rule of the Regional Greenhouse Gas Initiative  
Cap-and-Trade Program  
May 22, 2006**

In general, the Attorney General's office supports the RGGI carbon dioxide emission reduction program. Global warming is undoubtedly the most significant environmental problem facing America today and the RGGI cap-and-trade program is a good first step to reducing emissions from power plants, one of the two main sources of CO<sub>2</sub> emissions in the northeastern states. However, while it is a good first step, it is by no means sufficient. Unless it is replaced by an effective federal program, significant additional reductions in the regional cap will be needed. The science is clear that reductions of 80% or more in worldwide carbon dioxide emissions are eventually needed in order to stabilize the climate.<sup>1</sup> Because the United States is the world's largest source of carbon dioxide emissions and power plants are the largest source of emissions within the United States, reductions of that magnitude will ultimately be needed from the domestic power sector. RGGI is a good first step in that direction.

These comments will focus on two overarching issues that are critical to the success of the RGGI cap-and-trade program as a viable mechanism to reduce CO<sub>2</sub> emissions and provide a model for future reduction programs at the state and/or federal level: (1) selecting an allocation methodology; and (2) preventing inflation of the cap on regional CO<sub>2</sub> emissions.

**I. ALLOCATION OF CARBON DIOXIDE ALLOWANCES**

Now that the RGGI states have agreed to implement a carbon dioxide cap-and-trade program, the states must decide how to initially distribute the carbon dioxide allowances. Generators will need to have enough allowances to match the amount of

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<sup>1</sup> See *Climate Change 2001: Synthesis Report*, Intergovernmental Panel on Climate Change (Cambridge University Press 2001), Figure 6-1.

their CO<sub>2</sub> emissions, in a ratio of one allowance per ton of CO<sub>2</sub> emitted. Among the options are: distributing the allowances to generators free-of-charge based on historic emissions, distributing the allowances free-of-charge based on electricity generation output, and auctioning the allowances to generators and using the auction revenue for some public purpose.

The importance of the allocation methodology transcends this limited emission reduction program. As the federal acid rain experience demonstrates, the allocation methodologies chosen now may well develop their own propulsion and provide the default choice for future reduction programs as well. In addition, considering the need for additional reductions in the future, it is essential that the allocation methodology minimize the burdens of the program to the public at large in order to build public support for the further reductions that will be needed in the future, both at the state and federal levels. The state memorandum of agreement requires that at least 25% of the allowances must be sold to generators through an auction or similar mechanism for the public benefit. It is our view that the public benefit allocation should be expanded from the 25% minimum to 100% of the allowances.

Three principles should guide the selection of an allocation methodology. The first goal is to minimize the impact on consumers' electricity bills. Second, the allocation methodology should provide an incentive for development and implementation of clean sources of energy and energy efficiency. Third, the states should select an approach to allocation of allowances that ensures that CO<sub>2</sub> emitters bear at least some of the cost of the harm caused by their emissions but borne by society at large, otherwise known as the externalities of their pollution.

Principles of economics and the modeling undertaken by the working group demonstrate that all of these goals are served by developing a mechanism whereby the allowances are auctioned to generators with all proceeds used for energy efficiency improvements and direct ratepayer or resident rebates.

### **A. Free Allocation vs. Auction of Allowances**

Free allocation of allowances to CO<sub>2</sub> generators will not lead to lower electricity prices to consumers. The price of electricity will rise to the same extent under RGGI whether the allowances are given to the generators for free or auctioned for the benefit of the public. The reason is a matter of fundamental economics.

In New York and other RGGI states, electric power is bought and sold on wholesale spot markets (the NYISO, ISO-NE, and PJM). Load serving entities, such as utilities and competitive energy service providers, purchase power from generators at a price set by the market.<sup>2</sup> Generators offer power into the market at a price which represents their marginal cost (which includes all variable and fixed costs). The independent system operator matches generator offers with demand bid into the market, from least to most expensive power offered. When the demand is satisfied, the price at which it is satisfied, the “market clearing price,” is paid to all generators who have offered power at or below that price.

A generator will include in its variable costs, and thus in its offering price, the current market value of the CO<sub>2</sub> allowances it uses to cover its emissions, regardless of how it originally obtained those allowances. This is because, in offering power into the market, a generator has to decide whether it is more profitable to produce electric power and expend the necessary CO<sub>2</sub> allowances to do so, or not to produce electricity and instead sell its allowances to others. If it decides to offer power, it is foregoing the opportunity to sell the allowances in favor of consuming the allowances. This “opportunity cost,” which is the market price of the allowances, is a variable cost that will be included in generators’ marginal cost (i.e., the marginal bid price for the electricity they generate). The opportunity cost represents the cost to the generator of deciding to produce the power and use up allowances. The same opportunity costs will be included in the generator’s bid regardless of how the allowances were originally

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<sup>2</sup> Some power is also purchased through bilateral contracts.

dispensed.<sup>3</sup>

The price of electric power is ultimately passed on to the consumer, whether in the form of a direct pass-through on the bill (such as most New York electric customers get) or indirectly through recalculations down the road when fixed rate services are revisited by ratemaking agencies or when bilateral contracts are renegotiated or otherwise adjusted. Since the opportunity cost will be included in the generator's bid price regardless of how the allowances were originally dispensed, giving the allowances for free to the generators will not lower the ultimate price paid by the consumer. It will simply provide a windfall to generators, who will be able to keep or sell the allowances received as needed. An auction would not provide such a windfall, but instead would generate revenue for public purposes, including reduction of electricity bills.<sup>4</sup>

Cost studies for RGGI and other CO<sub>2</sub> cap-and-trade programs confirm that the electricity price impact of the CO<sub>2</sub> policy is the same whether under an historic allocation or under an auctioned allocation. However, the allocation methodology will have a significant impact on who benefits from the value of the allowances. For example, Resources for the Future (RFF) found that "due to electricity deregulation in the northeast, allowance value is reflected in electricity price to an equal degree for auction and historic approaches to distribution," and generators would actually make more money under a CO<sub>2</sub> policy with free allocation of CO<sub>2</sub> allowances than they would

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<sup>3</sup> See, e.g., Center for Energy, Economic & Environmental Policy, Rutgers University School of Planning and Public Policy, Evaluation of CO<sub>2</sub> Emission Allocations as Part of the Regional Greenhouse Gas Initiative, Final Report, (June 30, 2005) ("CEEER Report"), pp. 14-18.

<sup>4</sup> The CEEER Report sums up these points succinctly: "The initial impact on wholesale electricity prices is identical under historical allocation and auction, but with auction states may be able to lower substantially the impact on prices by using auction revenues to increase energy efficiency, provide consumer rebates or reduce transmission and distribution costs." *Id.* p. 18.

in the absence of a CO<sub>2</sub> policy altogether.<sup>5</sup> In contrast, the value of allowances in an auction approach (i.e., the auction revenues) would benefit the public if used for rebates and energy efficiency improvements.

In the UK, where CO<sub>2</sub> allowances were originally distributed at no charge based on historic emissions, it is anticipated that power generators will make increased revenue of approximately \$500 million per year.<sup>6</sup> Importantly, the Environmental Audit Committee of the UK House of Commons has concluded that auctions should be considered in future due to the massive windfalls generators have received.<sup>7</sup>

Allocating allowances by auction also promotes the development of cleaner sources of energy, because cleaner energy sources will not have to bear the cost of acquiring allowances. This will give renewable energy and efficient generators a modest competitive advantage over higher emitting generators, who already receive what is in effect a competitive advantage by obtaining free disposal of generation wastes such as carbon dioxide and other air pollutants.<sup>8</sup>

## **B. Auction Revenues**

As mentioned above, distributing allowances by auction eliminates the windfall to the emitters and allows the proceeds to be used to defray the increased prices.

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<sup>5</sup> Burtraw, D., Palmer, K., and Kahn, D., "Allocation of CO<sub>2</sub> Allowances in the Regional Greenhouse Gas Cap-and-Trade Program," Resources for the Future, March 29, 2005, p. 4. See also Center for Energy, Economic and Environmental Policy, "Evaluation of CO<sub>2</sub> Emission Allocations as Part of the regional Greenhouse Gas Initiative," June 30, 2005.

<sup>6</sup> House of Commons Environmental Audit Committee, "The International Challenge of Climate Change: UK Leadership in the G8 and EU," March 16, 2005.

<sup>7</sup> Id. at p. 17.

<sup>8</sup> To the extent that any allowances are not auctioned, they should be allocated on the basis of generation such as per MW delivered to the grid, not emissions or heat input, in order to provide renewable and efficient generators with a competitive advantage over higher emitting generators. While preferable to a historic emissions allocation, a generation-based free allocation would not generate revenues for public benefit purposes the way the auction approach would.

Through mechanisms such as rebates, credits and offsets, some portion of the proceeds can be returned directly to ratepayers who would otherwise bear the increased cost of electricity. In addition, auction proceeds can be used to fund energy efficiency programs directed at reducing consumers' electricity usage. In this way, the effect of increased electricity prices on consumers' bills will be tempered, if not eliminated. Furthermore, to the degree improvements in energy efficiency may reduce demand, such improvements can lower both wholesale energy prices and the cost of allowances.

More specifically, the Attorney General's Office supports using 50 percent of auction revenues to support existing energy efficiency programs in New York State that are administered by the New York State Energy Research and Development Authority (NYSERDA). NYSERDA has capably administered the System Benefits Charge (SBC) program, and is well-positioned to use additional funds from an auction to further these efforts. Through 2004, NYSERDA's energy efficiency and clean energy programs have reduced annual electricity use by 1,400 gigawatt-hours, reduced energy bills by \$195 million annually, created 4,200 jobs per year, and reduced annual carbon dioxide emissions by 1,000,000 tons.

New York's existing energy efficiency program has been a great success, but there is still potential for further efficiency gains. By 2022, NYSERDA estimates that the potential energy savings from additional cost-effective energy efficiency improvements could be as high as 27,244 gigawatt-hours per year. Auction revenues could be used to help realize the full potential of energy efficiency in New York. In addition to directly reducing energy use and therefore carbon dioxide emissions (and making the cap more easily achieved), improvements in energy efficiency that reduce demand may have an impact on lowering both wholesale energy prices and the cost of allowances. Of course, efficiency measures will also directly reduce the total bill of those consumers that implement such measures, offsetting any possible per unit rate increase. We recommend that this use of RGGI revenues supplement – rather than supplant – the existing SBC energy efficiency program to ensure that New York achieves the greatest total benefits of efficiency. With both SBC and RGGI funds used

to assist consumers in reducing their demand for energy, any effect of increased electricity prices on consumers' bills caused by RGGI will be minimized if not eliminated.

In addition to using 50 percent of auction revenues to support efficiency programs, other auction revenues should be used directly to offset increased per unit electricity prices that are expected to result from the RGGI program. The Attorney General's office recommends returning each year 50 percent of auction revenues to ratepayers to offset increased electricity prices so as to reduce consumer bills. This offset should be structured in a way that does not reward greater electricity usage, such as by being an offset on a per-customer charge rather than as a offset based on electricity usage (e.g. a per kilowatt-hour rebate). If it were structured on a per customer basis, it would be proportionately greater for citizens who use less electricity (rewarding conservation and efficiency), and the dividend would be more significant (in percentage of income) for lower-income households than for higher-income households. The offset should also be structured to provide a larger benefit to the lowest-income consumers, such as those already participating in low-income energy assistance programs.

### **C. Internalizing Externalities**

The RGGI modeling demonstrates that the financial interests of most generators will be served by providing them with allowances free-of-charge, rather than requiring them to pay for their allowances. But no system of environmental regulation is without costs to the regulated industry and it makes economic sense to require the generators to internalize the true societal and environmental costs of their emissions.

Since higher emitting plants cause greater societal and environmental harm, it is appropriate for them to have to pay for the greater number of allowances they need to cover their higher CO<sub>2</sub> emissions. If, as a result, some of higher-emitting plants are ultimately replaced by cleaner, more efficient sources of energy, then the program will be working as it should.

## **II. INFLATION OF THE REGIONAL CAP**

Especially given the modest reductions in CO<sub>2</sub> emissions currently targeted under RGGI, the Attorney General's office is concerned that certain provisions in the Draft Model Rule may, as a practical matter, increase the number of allowances available, thus in effect inflating the agreed-upon cap on regional emissions. The RGGI agreement holds CO<sub>2</sub> emissions flat from 2009 through 2014 and then decreases emissions by a total of ten percent through 2018. That emission target is achieved through a specified limit on the total number of allowances. But if plants are permitted to emit CO<sub>2</sub> under certain circumstances without needing allowances to match those emissions, the number of allowances and the cap will have been effectively raised and RGGI's goals will not be met. Such a cap inflation will undermine RGGI's efficacy in reducing greenhouse gas emissions and its viability as a model for future reduction programs at the state and/or federal level. Two provisions of the Draft Model Rule threaten to inflate the cap in this way and should be revisited: (1) the exemption for units burning 50% or more biomass (the "biomass exemption"); and (2) the early reduction allowances ("ERA") provisions.

### **A. The Biomass Exemption**

RGGI contemplates that power plants may reduce CO<sub>2</sub> emissions by co-firing biomass with coal. As an initial matter, the Attorney General's office is concerned that the definition of biomass contained in the Draft Model Rule (Subpart XX-1.2(f)) includes materials that potentially may not result in net CO<sub>2</sub> reductions. If the biomass utilized for combustion is obtained from operations that result in the net deforestation of land, for example, the CO<sub>2</sub> assimilative capacity of the land will be reduced, potentially resulting in net positive CO<sub>2</sub> emissions. RGGI should require that all biomass-derived fuel be carbon neutral, or at a minimum, result in a net reduction of CO<sub>2</sub> emissions.

As currently drafted, the Draft Model Rule only applies to fossil fuel-fired units "where the fossil fuel combusted comprises, or is projected to comprise, more than 50 percent of the annual heat input on a Btu basis during any year." Section XX-1.2(af). Thus, a unit that burns 50 percent or more biomass is entirely exempt from the need for



allowances, even if it is still burning up to just under 50 percent fossil fuel. In that case, none of the CO<sub>2</sub> emissions, even those from fossil fuel use, will be matched by allowances. This will effectively increase the cap, and regional CO<sub>2</sub> emissions, by the amount of the unmatched fossil fuel emissions. We see no reason to provide such a blanket exemption from coverage for fossil-fuel fired units that burn 50% or more biomass. Rather, all emissions from power plants that are associated with the use of fossil fuels, except for a de minimis use of fossil fuels (such as for start-up),<sup>9</sup> should be subject to the cap. The biomass exemption should be limited to the specific emissions associated with the use of biomass. The biomass emissions may be separated from the fossil fuel emissions by using the formula set forth in Section XX-8.5(d)(2)(iii). Similarly, there should be no exemption from monitoring requirements for such units; the owners and operators of all units having a rated capacity equal to or greater than 25 megawatts that burn all but a de minimis amount of fossil fuels should be subject to the monitoring and reporting requirements of Subpart XX-8.

#### **B. Early Reduction Allowance (ERA) Provisions**

The Draft Model Rule provides for ERAs to be awarded by states to companies that reduce CO<sub>2</sub> emissions before 2009. This provision appears to be intended in part to avoid penalizing those companies that reduce CO<sub>2</sub> emissions early under the scenario in which the state awards allowances free-of-charge to generators starting in 2009. Since the allowances will have a significant financial value, a generator that reduces its emissions early – in the “baseline” period – before 2009 will receive fewer allowances after 2009 than if it had not acted early, thereby being penalized for reducing emissions before the start of RGGI. The ERA proposal would avoid this “unfair” result. (If, as we recommend, allowances are 100 percent auctioned, however, there would be no such penalty to those who act early, and no concomitant windfall to those who did not act early.)

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<sup>9</sup> This amount may be specified on either a percentage basis (e.g., less than 5%) or tonnage basis (e.g. XX tons of CO<sub>2</sub> per year).

It appears that the Draft Model Rule would allow ERAs to be awarded by a participating state as an addition to the state's emissions cap or "base budget." This would effectively create additional allowances and would inflate the regional cap. Rather, the Model Rule should provide for states to allocate ERAs out of their existing cap, rather than to allocate additional allowances on top of the cap.

Even if 100 percent of the allowances are auctioned, ERAs may be used to create an incentive to take earlier action. If ERAs – out of the total cap for the initial compliance period – could be allocated for free to those generators who reduce emissions early, this should reduce the number of allowances to be auctioned upon commencement of the program in 2009. By giving generators who act early to reduce emissions the ability to obtain for free allowances that they would otherwise have to purchase, this method for awarding ERAs would provide an incentive for generators to take action to reduce their emissions prior to 2009.

In the event that the state distributes some allowances free-of-charge based either on electricity generation output or historic emissions, it could still award ERAs out of the existing cap. Under this scenario, the ERAs awarded to generators prior to 2009 would reduce the allowances available free-of-charge to all of the generators during the initial compliance period after the start of the program. The reduction in allowances during the initial compliance period would be spread out among all of the generators, with those who received ERAs getting the same percentage of allowances they would have received had they waited until after 2009. Thus, generators who act before the program starts would have an opportunity to obtain more allowances, which may then be sold, than had they waited until the program starts.

### **III. SUMMARY**

We strongly urge the RGGI states to provide for all allowances to be auctioned or, in other words, allocated to the public. We recommend that approximately one half of the proceeds be directed to energy efficiency programs, and one half to direct consumer rebates, with some targeted to low-income consumers. In addition, we recommend that the regional cap on emissions be tightened so that all emissions from

power plants that are associated with the use of fossil fuels, except for a de minimis use of fossil fuels, be subject to the cap and early reduction credits be allocated out of the existing cap.

Thank you again for considering the views of the Attorney General's office on these important issues.