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COMMENTS OF CONSERVATION LAW ON “THE RGGI PHASE 1 AUCTION DESIGN REPORT (DRAFT)”

Submitted June 15, 2007 by Seth Kaplan, Senior Attorney & Director, Clean Energy and Climate Change Program

The Conservation Law Foundation appreciates the opportunity to offer comments on the draft paper regarding design of a regional auction of RGGI allowances.

The importance of this work is difficult to overstate. It is very likely that when history tells the story of the RGGI effort the redefinition of cap-and-trade through introduction of large scale allowance auction is likely to be a central part of the narrative. The RGGI process has been part of a critical global and national movement towards recognition of cap-and-trade with auction as a critical tool for regulating and reducing harmful emissions. And as the saying goes, god (and the devil) can usually be found in the details, and this design process is about drilling down into those details.

The team working on these issues seems to be extremely well qualified and open to input from a range of stakeholders. We complement NYSERDA and the New York State staff, and in particular NYS DEC staff, for setting up a fast moving but thoughtful process that is making a real and effective effort to reach out to stakeholders, explain complex material, and collect substantive input.

THE IMPORTANCE OF AUCTION DESIGN IN ADDRESSING SUBSTANTIVE CONCERNS, INCLUDING RELIABILITY ISSUES

Many of the substantive concerns that have been raised about the RGGI program, particularly concerns about availability of allowances to meet the needs of generators, can be addressed in large part through the kind of design issues being discussed here. The vision underlying the draft report and the structure it recommends addresses these concerns in some ways, and can be easily expanded to address these concerns even further, specifically:

- **Denominating allowances in three year increments is an important step in calming concerns about availability and reliability** – this step ensure that at the beginning of each three year compliance period, and as the period unfolds, each market participant (including emitters) has a wide range of options ranging from a strategy of purchasing allowances “up front” to maintain a supply of allowances equivalent to emissions at all times to a strategy of “waiting and seeing” secure in the knowledge that any allowance purchased during the compliance period can be applied to emissions generated during that period;
- **Conducting quarterly auctions will aid in this process of providing assurance about availability** – emitters and other market participants will know that at any given time a fresh set of allowances will be introduced into the “pool” (and secondary market) every three months, quarterly auctions will also promote rational price discovery and ensure that market instability and swings attributable to strategic behavior and

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new information will be appropriately dampened by the fact that only 1/12th of the allowances will be auctioned at any given time;

- **The proposed design of an English clock with a shootout round, for at least the initial auction of a vintage, will deter collusion and help defuse concern about availability and reliability** – by ensuring that allowances are freely and fairly dispersed through an initial auction that is calibrated to deter collusion this design provides real price discovery and promotes market stability – while (of course) leaving the door open for implementation of a simpler auction in later auctions within a compliance period after the price and market have settled;
- **Robust and effective market monitoring of the secondary market will assist in addressing concerns about availability and reliability** – a transparent secondary market where registered participants in the primary market (and all persons and companies affiliated with them) are required to publicly disclose the sale and purchase of allowances will go a very long way towards defusing any concerns about hoarding or attempts to corner the market – the designers and operators of the primary market have a unique opportunity to create this information mechanism by requiring total transparency regarding secondary transactions as part of the “price for admission” to the primary market (essentially making it a contract restriction on market participants). This kind of regulation through information sharing would be much preferred to a mechanical solution like limiting the number of allowances a participant could purchase, a mechanism that would create artificial market barriers, hinder price recovery and even potentially create a false perception of a reliability issue if an emitter was not allowed to purchase the allowances they felt they needed. The information gleaned from a transparent secondary market, combined with data from the ISO electricity markets will show the actual state of the market in terms of meeting the need for allowances to maintain system reliability.

ALL REASONABLE STEPS SHOULD BE TAKEN TO CREATE AN ALL-STATES REGIONAL AUCTION

The success of the auction and the market that it initiates will turn in part on there being sufficient volume of allowances “in play” with a high degree of certainty around the timing and manner of the release of the allowances. Therefore, it would be optimal if all states engage in RGGI participated in the regional auction – this is even truer if contract restrictions attached to allowances at the regional auction are the backbone of a transparent secondary market.

The very different fiscal situations of the states should be taken into account in designing the regional auction mechanism and apportioning financial responsibility for the auction and the Regional Organization.

THE IMPORTANCE OF SETTING A RESERVE PRICE

Lastly, we note the convergence between good auction design and concern that the initial RGGI caps (expressed by environmental stakeholders over the last two years) are unrealistically high and do not decline quickly enough. Reserving (not selling) allowances in early auctions when bids fall below a reserve price defends against gaming and market manipulation and moves toward the important goal of long-term price discovery. If allowance prices do not clear the reserve price in multiple auctions then a critical signal is being sent by the market regarding the fact that there are more allowances available under the cap than will be needed, regardless of whether the unsold allowances are required after several auctions (a positive step that would de facto tighten the cap) or are continued to be offered for sale. Such a discovery would inform decision making regarding ongoing operation and design of RGGI and other CO2 regulatory mechanisms.

Thank you, again, for this opportunity to comment.