

To: RGGI State Environmental and Energy Commissioners and the Staff Working Group
From: Environmental Defense
Date: October 18, 2005
Re: Draft Comments on the August 24, 2005 Revised Staff Working Group Package Proposal

The Governors of the nine states participating in the Regional Greenhouse Gas Initiative (RGGI) stand poised to take an historic first step to address climate change by creating an enforceable mechanism to cap greenhouse gas emissions from an important sector. We urge the directors of the State Agencies to complete discussions and adopt a framework based largely on the Staff Working Group proposal posted on August 24, 2005. In our view, the Staff Working Group Package represents a reasonable first step in addressing climate change and reflects compromise among a diverse set of interested parties. We ask all of the states participating in RGGI and those states observing its progress, to complete the MOU and rule development process. Environmental Defense looks forward to working with each state on these important tasks.

Environmental Defense supports cap and trade programs as a means of achieving superior environmental performance while managing cost. The first principles of such program in the Northeast should include:

- a. A firm and enforceable cap on CO₂ emissions
- b. A focus on achieving the largest amount of reductions feasible for the lowest cost
- c. Mechanisms for cost-effective, high-quality greenhouse gas reductions to be incorporated into the program

Environmental Defense recognizes that as one of the first-of-its-kind programs in the United States, there is much compromise that went into completing the package proposal. Generally, we believe that the program has a good chance of meeting our first principles and can serve as a working model for the nation. In the interest of helping to further improve the program, we offer the following comments for consideration in what we hope are your final discussions before adopting an MOU among the states.

1. Compliance Period and Program Review: We think RGGI should consider a shorter compliance period. The objectives of using a market are to create liquidity and in turn send timely and accurate price signals to the participating sources. We are concerned under a three-year cycle, most trading will occur close to the compliance deadline and therefore will undermine the objectives of using a market. Environmental defense also thinks it will be important to review the program after each three-year compliance period. Throughout these comments we describe things that should be reviewed during each program review, they include: post 2020 reduction goals, comparison of projected to actual regional emissions in the lead-up to 2009, leakage, use of the set-asides and use of offsets. Please see the comments under each section for more detailed discussion of how to conduct the reviews.

2. Reduction Goals: Environmental Defense supports the UNFCCC objective of stabilizing greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous

anthropogenic interference with the climate system. In order to meet this long-term goal, reduction levels will ultimately need to be set at levels that are much lower than those proposed by RGGI and they will need to cover virtually all sectors of the global economy. Environmental Defense would prefer to see much stronger reduction targets in the RGGI package. If the RGGI States are not prepared to accept a tougher limit at this time, we ask they consider three modifications to the proposal:

- i.* Clarify the language describing the reduction goals so that there is no ambiguity about the first stabilization cap. The cap level of 150.6 million tons per year represents the Staff Working Group's best estimate of what emissions will be in 2009, not what they are currently. Current emissions are more than 5 million tons lower than this number so any reference to "current emissions" makes it appear that the program is making false claims.
- ii.* Establish a more concrete long-term price signal by adopting a provision to consider a further reduction in the cap after 2020 during the earlier program reviews.
- iii.* Establish a method to monitor the variance between projected 2009 emissions and actual 2009 emissions. In the event actual emissions are significantly lower than projected, consider a phased in approach for reducing the overall cap by at least the amount of overage in order to stimulate market liquidity and to "hold the environment harmless" for the variance. RGGI might consider making an adjustment over the following 5-10 years in order to avoid problematic disruptions in the cap and trade system.

Uncertainty in energy prices and plant performance can have a major impact on "business as usual" emission trajectories. If emissions are actually higher than projected, the reduction targets will seem even more difficult than planned as allowance prices rise, and conversely, if actual emissions are lower than projected, the reduction targets will be less meaningful as allowance prices drop and surplus allowances abound. This uncertainty gives rise to a concern about perception of the program and also to a concern about market functionality.

Environmental Defense views these concerns with a long-term perspective in mind. Over the long-term, we believe that greenhouse gas emissions will have to be reduced at even greater levels than called for in the current package and so we can accept a start-up period that may or may not be as rigorous as we'd like as long as it has the dual features of a verifiable emissions baseline and enforceable emissions targets. We believe that given regional emissions trends, it would be better to set the initial cap at a level that was closer to current actual emissions.

The potential gap of roughly 5 million tons amounts to 3% of the cap level. If, the decision is not made to reduce the cap, then we urge the RGGI states to establish a monitoring program to determine the extent to which the initial cap differed from actual emissions at the start of the program and consider using some mechanism like the Strategic Carbon Fund to buy back those emissions over time, in effect holding the environment harmless for an incorrect projection. If such a discrepancy is found we think it can be bought back over a period of years out in the future in order to be built into planning horizons.

Finally, there has been much discussion of using mechanisms known as safety valve or price caps which would be used to relax or toughen standards based on the price of CO₂ allowances. Environmental Defense applauds the Staff Working Group for not including such provisions in the proposal and would like to take this opportunity to strongly state its objection to such price triggers as mechanisms for making contingent decisions about the design of the program. In our experience, these mechanisms distort incentives and the market in a way that undermines program objectives.

3. Allowance Allocations: Environmental Defense is concerned that any allocation method chosen not result in unintended consequences. There is a significant amount of study underway to determine the effects of the allocation methods in competitive electricity markets as well as mechanisms for mitigating those effects. Some of those studies indicate that regardless of the allocation method, the wholesale price of power is likely to increase to reflect either the cost of allowances distributed through an auction or the opportunity cost of allowances if allowances are given to generators. We note that auctioning allowances may create an added layer of transaction cost and complexity to the emissions trading market. We do not think that RGGI should be delayed to find the answers to these concerns, but we do think you should set in motion a program to collect the data necessary to fully assess the impacts, define the problems and develop appropriate solutions. Further, we urge RGGI to ensure that any requirements for allocation methods in the Draft Model Rule do not trigger unintended regulatory or legislative requirements within the RGGI states. In our view it is important to move forward to implement this program with the least delay rather than worrying further about allocation.

4. New Sources: It is our understanding that the individual state caps reflect some accommodation for new sources. Environmental Defense would like a clear accounting for those assumptions and would ask that new source set asides reflect those assumptions. In states where the assumed growth built into the cap is significant, this will be especially important in maintaining the environmental integrity of the program.

5. Leakage: Environmental Defense agrees that the potential for leakage of emissions is a real concern to the extent RGGI is implemented and other state and/or national programs are not implemented. However, our hope is that other programs will come on line. If this is the case we do not think there will be a great need to address leakage. We agree that the issue should be examined during the program review. If it is found to be a significant problem then some combination of the set asides should be used explicitly to offset leakage. If on the other hand, leakage is not viewed to be a problem, the program may consider reducing some of the set aside volume. It will be important for the states to determine the data necessary to make this assessment and to begin collecting it from the onset of the program.

6. Offsets: Environmental Defense generally advocates for cap and trade programs where all possible sources of reductions are covered by a firm emissions cap. This has been the case for SO₂ and NO_x trading programs. That said, we recognize the need for offsets in the context of the RGGI program in order to provide some flexibility, especially in the short-term, for participating sources. We believe that the ability to use real offsets will help to improve the program performance. We are also sympathetic to the desire of some to get meaningful greenhouse gas reductions at power plants to spur co-benefits such as reductions of other pollutants.

Offset Types: Environmental Defense supports the types of offsets that are planned to be eligible in the program and also endorses efforts to add new types of offsets to the program. The biggest challenge will be in developing criteria for approving offsets that ensures the reductions are real, verifiable, and quantifiable. These criteria and the mechanisms for implementing them are not spelled out in the package. Environmental Defense would be interested in working with the states to ensure the rules for creating offsets are environmentally sound. Environmental Defense would also strongly support provisions either in the model rule or the MOU that enable other states or sectors to opt-in to the program.

EU / CDM: Environmental Defense does not understand the logic in using a price trigger to determine whether EU allowances or CDM offsets could be allowed into the program. In our view, CDM credits are likely to be created under criteria that would be rigorous enough to meet RGGI standards. If so, they should be allowed into the program right away. EU allowances come from a capped program. It would seem that RGGI should determine whether it views the EU caps as being at least comparable to the RGGI program. If so, then EU allowances should also be allowed into the program. It is unclear how a price trigger would be used to regulate the use of these credits in the program, particularly given the proposal to allow them in at some point and then prohibit them once the allowance price drops below the trigger. We think it would cause undue and unnecessary confusion and uncertainty.

Limit on Use of Offsets: Environmental Defense believes it is more important to assure that any offsets are real, verifiable and quantifiable than it is to set a limitation on the number of allowances that can be used. We do not propose to reopen the compromise of setting a limit of 50% as described in the package at this late hour as long as the criteria for determining the validity of the offsets are sound. On the other hand at a later time, we would not oppose an increase in the limit, if the increase might help hold costs down, again, provided sound criteria for determining whether to permit an offset.

In Summary:

Environmental Defense has no doubt that as the RGGI program evolves there will need to be changes to reflect other state and national policies, our improving understanding of climate change and the advent of new technologies. Environmental Defense looks forward to working closely with the RGGI states over time to address these changes. The language in current draft is more than worthy of immediate implementation. Today, it is most important to start and we urge the RGGI Governors to take that step.