

AES
130 E. Seneca Street
Suite 505
Ithaca, New York 14850

January 24, 2007

To: chris.nelson@po.state.ct.us
chris.james@po.state.ct.us

Subject: AES Comments to Connecticut on State Implementation of RGGI

We appreciate the opportunity to provide comments to Connecticut as it develops its rule to implement RGGI. We are very concerned with the RGGI pre-proposal that was released by New York, and encourage Connecticut to reject its proposed 100% auction for the reasons outlined herein. New York's pre-proposal represents a complete departure from the claimed desire to achieve balance among environmental, energy and economic development needs and does not represent a workable template for a national program.

We therefore encourage Connecticut to develop program details that provide for a fair allocation of allowances to generators and address other shortcomings of New York's pre-proposal.

If you have any questions please contact me at 607/272-5970, ext. 1116.

Sincerely,

Chris Wentlent, Director
Regulatory Affairs

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1/24/ 2007

AES Overview

AES is one of the world's largest global power companies, with operations in 26 countries on five continents. We have 14 regulated utilities and 122 generation facilities worldwide, including our long term contracted AES Thames facility in Connecticut.

We were one of the first generating companies in the world to voluntarily offset carbon dioxide emissions through forest sequestration projects, have significant holdings in wind farms across the globe, have significant businesses in the creation of greenhouse gas offsets, and over the next 5 -10 years plan to invest \$10 billion in CO2 offset, renewable energy, ethanol, solar power, coal-to-liquid technology, and carbon capture projects.

More recently, in New York, we have announced plans to research and demonstrate improved carbon dioxide capture technologies with Praxair for both new and existing electric generation facilities. Once technically and economically feasible, such technologies would be capable of being retrofitted on both new and existing boilers across the country. To date, however, carbon capture and sequestration remain in the development phase. No viable CO2 capture and sequestration technology alternative currently exists.

In a recent January 6, 2007 NY Times interview, our CEO Paul Hanrahan, provided an overview of our climate change activities and specifically identified that in the interim, CO2 emissions could be reduced cheaply through the global utilization of offsets.

Since CO2 is a global challenge, AES believes that the best approach is a national CO2 legislative solution. However, in the interim, we will support a well-structured regional greenhouse gas initiative that properly balances environmental, economic development and energy needs as was promised in the RGGI Action Plan.

We have the following concerns with respect to the concept of auctioning 100% of allowances:

1. The shift to a 100% auction mechanism without fully understanding the market, economic, reliability, and investment implications including the immediate financial distress for a 100% contracted facility without a CO2 pass-through in its existing long term contract.
2. A 100% auction will not promote investment in new and existing infrastructure and will reduce the term of energy transactions.
3. The approach will not allow for the funding of control technology equipment when it becomes technically and economically viable.
4. Program design places the highest level of risk on both consumers and suppliers.

5. Program design is not “expandable and flexible” and, thus, will not serve as the template for a national program.

AES is concerned with so drastic a deviation from the RGGI Final Model Rule recommendation which provided for at least a 25% auction, with the remaining allowances to be allocated to generation sources, to an immediate 100% auction mechanism with no allocation to generation sources.

The broad-brush rationale used to support this change, “that all generators will receive “windfall” profits if allocated allowances” is flawed. Even highly efficient natural gas fired facilities that are able to recover most of the RGGI allowance costs within their bids will face cash and collateral issues that will limit their ability to enter into longer term transactions. Moreover, oil and coal fired generating capacity will outright face substantial economic harm, not profit windfalls, if a 100% auction is utilized. At a time when economic development and infrastructure improvements are critical priorities, a program design that could negatively impact current existing infrastructure needlessly presents significant risks.

100% Auction Impact – Impact on Different Commercial Arrangements & Fuel Types

Various policy statements prepared by state agencies and boards have identified fuel diversity as an issue of concern that should be addressed through effective regulations that encourage diversity. As stated in the CT Energy Advisory Board’s (CEAB) “Energy Plan for Connecticut, January 2006, “[a]ccording to the “Regional System Plan 2005” approved by ISO New England, the diversity of fuels used to generate electricity in New England is an issue of concern. The short-term issues relate to a large portion of the gas-fired generating units’ lacking either firm gas contracts or dual-fuel capability. The longer-term issues relate to the high and increasing reliance on natural gas for producing electric power in New England and neighboring regions, suggesting the need for greater electric supply-side fuel diversity in the region.’ Also, in February 2000, the CEAB’s Energy Policy Report stated; “[t]he Board recommends that it be the policy of the state to continue to develop effective regulations, that are consistent with energy policy goals and with new trends in energy markets and technology, to cost-effectively comply with the Clean Air Act and to further reduce air and other environmental impacts to protect the health of Connecticut residents. Since the primary responsibility for environmental policy and regulation rests with the Connecticut Department of Environmental Protection (DEP), effective coordination of energy and environmental policies will be key to success in this area.” Further, the recent Connecticut Siting Council (“CSC”) report “Review of the Ten-Year Forecast of Connecticut Electric Loads and Resources 2006-2015”, which reviewed and analyzed electric loads supply and demand through 2015, concluded that Connecticut could face a significant generation capacity shortage throughout the forecast period. CSC 2006-2015 Ten Year Forecast, November 14, 2006, p. 7. The CSC concluded that to assure the electric system’s long-term reliability, the state needs to focus on facilitating the addition of new generation in Connecticut, avoid excessive

reliance on any one fossil fuel for generation and encourage innovations. CSC 2006-2015 Ten Year Forecast, November 14, 2006, p. 23.

Long-Term Contracted Facilities

Connecticut and the RGGI region have a number of contracted plants, with long term power contracts, that do not contain a CO₂ pass-through. Our AES Thames facility is the cleanest coal-fired facility in New England and provides steam to a cardboard recycling facility. Failure to provide a mechanism for these facilities to recoup their CO₂ costs is likely to either cause unit shut down or, at a minimum, force default under the terms of the contract and an associated change of owner. The contracted plants impacted, throughout the RGGI region, are some of the most modern, environmentally efficient facilities in the state and region. Many of these facilities operate with natural gas as its primary fuel, state-of-the-art control technologies and provide cogeneration capability to a neighboring business. The potential unintended outcome of a 100% auction program design will be that states that adopt this approach will carry a higher regulatory risk premium than other markets or (states) when competing for the next new capital investment.

Merchant Coal-Fired Facility Impact

Gas plants generally set the marginal price of power, and will for the most part recoup the cost of CO₂ allowances in the price they get for their power. A combined cycle gas-fired plant emits CO₂/MWH on roughly a 1:2 ratio as compared to coal units. Accordingly, a coal fired unit will recoup approximately 40% of its CO₂ cost from the market. The remainder will be an immediate financial consequence to the facility.

Assuming a CO₂ allowance price of \$5, this equates to a market recovery of roughly \$2/MWH for gas-fired generation that will be included in their bid price. Therefore, with these plants setting the marginal price of electricity a majority of the time, all merchant generators (including coal-fired) will get a \$2/MWH incremental price for their power. (AES Thames is a contracted coal-fired facility and would receive \$0/MW through 2015, the remainder of their contract life.)

Merchant Oil-Fired Facility Impact

Oil fired generating facilities generally are less cost effective than an efficient gas fired facility. Oil facilities require allowances on a 1.5 to 1.0 ratio as compared to gas facilities. Accordingly, this type of facility will operate at even lower capacity factors, will lose net revenue margin on the limited peak system condition occasions that they do run and become totally dependent on the capacity market or reliability must-run contracts for revenues to continue operation.

Offsets

Most stakeholders will agree that CO₂ Capture and Sequestration technology is still in its formative stage. In the interim, offsets provide a reasonable, verifiable and lower cost path as a compliance option to control CO₂ emissions. There are no environmental or economic reasons to control the percentage and geographical location of quantifiable offset projects. Broader application of offsets provide low cost compliance options, result in net CO₂ reductions, reduce environmental and economic leakage at RGGI borders, and assist in CO₂ price control. Consumers and suppliers are both better protected with expansion of the offset program.

Investment (New & Existing)

The litmus test of good policy is whether the proposed guidelines will support investment in new and existing facilities. Without a commercially available solution, a 100% auction approach will make investment and capital financing of new fossil generation extremely difficult by creating the need to cover up to twenty (20) years of CO₂ risk at the front end of a new project. Without an auction protocol available, it makes further analysis of this potential more difficult.

In addition, with respect to existing facilities, the successful structure of the SO₂ and NO_x programs (both federal and state) resulted in low cost energy, reduced emissions, and the addition of new technology. Under those programs, when considering a control technology solution, both the improved dispatch cost and sale of unused allowances due to the equipment upgrade were considered when making the capital decision. Under a 100% auction approach, since the source receives no allowance allocation, all future CO₂ investments will be forced to only depend on long term energy forecasts to make investments that could range in the \$150-300 million dollar range depending on size of the facility.

To date, neither the Regional Model Rule nor the New York State Pre-proposal has provided any roadmap to site and develop new fossil generation. At a time when new generation is critical, leaving the mechanism for new investment to chance is not in Connecticut's or the region's best interest.

Need for Additional Studies

Finally, a number of key areas of the RGGI Program remain without adequate support or analyses including the following:

- Economic and Environmental Leakage Analysis
- Auction Design Specifics

- Full reliability review with written summary
- Modeling which incorporates the effect of 100% auction methodology.
- Sensitivity studies of CO2 market and reliability impacts at different CO2 allowance price points.

To date, none of these important analyses have been provided and they are necessary to fully evaluate any proposal and its total impact.

Summary

Connecticut and other RGGI states are at a critical energy crossroad. It is important that we get it right because of the critical and immediate capacity needs that exist. Further, it is imperative we get it right so that it can form the template for a national program. The final outcome must support our existing needed infrastructure, provide investment signals for new investment, and minimize price impacts on consumers as much as possible. AES will support a reasonable, well structured CO2 program. However, a program with the problematic areas that we have identified does not balance environmental, economic development and energy needs.

We believe the Regional Model Rule as originally designed and approved only months ago was on the right track with respect to allocation methodology for auction and merchant generation sources. However, we suggest additional thought must be given to how long term contracted plants are addressed, greater flexibility in offset utilization is needed and completion of the required studies are necessary.