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Regional Greenhouse Gas Initiative (RGGI)
Auctioning Position Paper

Overview

The Model Rule for RGGI has been completed, and each participating state is in its process of implementation. Although the Rule calls for a set-aside of 25% of the total allowances for "consumer benefit or strategic energy purpose", regulators in New York have proposed something more extreme: an auction of 100% of the allowances. The N.Y. Department of Environmental Conservation (DEC) is hosting a hearing on January 12 to hear public comments on the auctioning issue in advance of finalizing its proposed rule.

This position paper details the reasons that full auctioning is not sound market design. Simply put, full auctioning will lead to market inefficiencies and higher costs of compliance. Most important, it will limit the overall benefits to the environment.

If implemented with 100% auctioning, RGGI would not achieve its market or emissions reduction potential. It would achieve compliance with its cap, but not incentive-driven additional emissions reductions. It would have unnecessarily high compliance costs that would also impact regional energy markets. Finally, it would direct millions of dollars to a state fund, instead of to emissions control investments.

Inefficient Allocation of Capital

Every existing emissions cap and trade program has had an allocation process that distributed allowances to affected entities based on a baseline or some historic emissions level. In contrast, an initial auction does not necessarily tie allowance costs to the cost of emissions reductions, nor any baseline. Full auctioning by definition provides no initial tons to incumbents. A program ostensibly based on a tradable commodity ironically finds that commodity completely missing. Consequently, options to seek efficiency from the start through trading are missing. Funds that must be committed to an initial auction compete with, rather than complement, funds for any emissions-abatement processes or equipment.

Furthermore, there is the distinct likelihood that auctioned allowances will be purchased by non-regulated entities – including speculators. To be sure, speculators play a vital role in markets by facilitating market liquidity. However, speculation under a state-run, 100% auctioned program has the potential to drive up the cost of allowances for regulated companies seeking them for compliance, needlessly increasing costs for both industry and consumers.

No Incentive to "Overcomply"

Under the New York proposal, industry is not given the incentive to find new and innovative emissions reductions at their own plants. Rather, they will struggle to conform through expenditures to buy allowances, or, at best, inefficiently seek to minimize the purchase of

allowances. On a practical level, this means that any reductions beyond those that are mandated are not rewarded financially and thus are unlikely.

Cap-and-trade systems are designed to benefit from disparities in the cost of abatement. These programs encourage entities with the lowest cost of abatement to "overcomply", so that they can sell their extra allowances to entities with a higher cost of abatement. Under full auctioning there will be no incentive to overcomply and thus greatly reduced prospects for trading. The economic efficiencies of the program will be significantly reduced, as will any potential emissions reductions beyond the mandated cap. The reason the U.S. SO_2 trading program is widely touted as a success is because it achieved its environmental goals much faster and cheaper than expected through trading. If implemented with full auctioning, RGGI will not match this success.

Finance for Investment

Cap-and-trade programs are not only designed to find the most cost-effective existing sources of emission reductions; when implemented correctly they also facilitate investment in major capital projects to reduce emissions. In the U.S. SO_2 program regulated entities are provided 30 years of allowances. If they choose, these companies can sell blocks of future allowances in order to finance the installation of control technologies or other major emissions reductions measures.

Such actions will not be possible under a RGGI program in which 100% of allowances are auctioned each year. Companies will be forced to sink capital into the purchase of allowances, eliminating a viable funding source. Full auctioning simply adds a significant upfront cost while reducing investment and abatement opportunities. Moreover, the RGGI states are contemplating multiple auctions on an annual (or greater) basis. Unlike under the 30-year timeline of the SO_2 market, covered entities under RGGI will have far less certainty of allowance supply, liquidity and price, and consequently will be less likely to make potentially valuable abatement investments.

Market Manipulation

The auctioning of allowances can also lead to market illiquidity and leave a program open to price manipulation. The U.S. SO_2 program incorporated an annual auction of approximately 2.5% of the total SO_2 allowance budget. Once the market began however, it became clear that auctioning in the US SO_2 market hindered market development rather than supported it. Trade volumes move considerably before each auction, as market participants await the results. These episodes are also fertile ground for price manipulation. Time and again in the SO_2 program, we have seen expectation-led price distortions in the run-up to and aftermath of the SO_2 auctions.

These distortions serve no beneficial purpose in the market. In a landscape of multiple auctions across RGGI states with differing allocation procedures, these complicating dynamics can only get worse.

Public Sector

Proceeds from the proposed full auctioning, potentially hundreds of millions of dollars, would flow to state funds under the Model Rule. Presumably, the States will invest these funds in initiatives that help reduce greenhouse gas emissions, but the exact investment decisions are discretionary. As we

have seen in the SO_2 and NOx cap-and-trade programs, as well as in the European Union's Emissions Trading Scheme, regulated entities find it profitable to find innovative and low-cost means to reduce emissions in a fully-incentivized trading program. This raises the question of who is more capable of investing energy industry funds: energy firms or state agencies. We believe the private sector has proven that it is more flexible, innovative and efficient in allocating capital in this industry than are government agencies.

Leakage

Finally, the added costs and uncertainty of the fully-auctioned program proposed by New York and other RGGI states will exacerbate an existing, serious concern with RGGI: leakage. That is, power purchasers will likely avoid the costs and complexities of RGGI by buying more from generators in neighboring states and provinces. Evolution Markets believes that GHG compliance in general, and the precedent-setting nature of RGGI, in particular, are too important to be fundamentally weakened by faulty program design.

(Note: The final public hearing on New York's proposed full auctioning of RGGI allowances will be January 12, 2007 at N.Y. DEC in Albany.)

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