



Testimony before the Connecticut Department of Environmental Protection Regarding RGGI Implementation

February 14, 2007

Thank you, members of the Connecticut Department of Environmental Protection (“DEP”), for allowing me to submit these comments in advance of the February 15, 2007 meeting. My comments address a number of Regional Greenhouse Gas Initiative (RGGI) issues that DEP plans to discuss today.

My name is Andrew Kruger. I am Vice President for Greenhouse Gas Markets at Evolution Markets, the largest global broker of environmental products. We operate from offices throughout the world, including in Connecticut, New York, San Francisco, Calgary, London and Bratislava. Our clients include more than 85 members of the Fortune 500, and we have brokered transactions in 23 nations. We also served as an advisor to New York Governor Pataki’s Greenhouse Gas Working Group.

Evolution Markets has been a pioneer in the development of emissions trading markets, including the European Union’s Emissions Trading Scheme, market mechanisms under the Kyoto Protocol, and the US SO₂ market, which was of course the first emissions cap and trade program and is the largest in the US.

In fact, my firm has been involved in every major emissions market, and I personally have nearly 20 years experience in emissions trading. I began my career as a regulator at the US Environmental Protection Agency and worked at AER*X, the nation’s first emissions brokerage. I was involved with the development and implementation of the US SO₂ cap and trade program, as well as both generations of the NO_x Budget program.

Moreover, I believe in the power of environmental markets - that market mechanisms can meet environmental goals in the most cost-effective manner. RGGI, too, can be a powerful force for the environment – if properly implemented.

I am before you today because I am concerned about the allocation proposal that was first suggested in New York, and which is now being considered by other RGGI states, including Connecticut: Specifically, the proposal to auction 100% of allowances under RGGI.

Based on our experience in emissions markets, Evolution Markets believes such a proposal is not only ill advised, but counterproductive to achieving environmental objectives.

And, Evolution Markets is not alone in this view. You may be aware of the recently-announced “United States Climate Action Partnership” (US CAP) a voluntary effort by major businesses and leading environmental organizations - including Environmental Defense; the Natural Resources Defense Council, the Pew Center on Global Climate Change and the World Resources Institute – that calls for mandatory federal action on greenhouse gas controls.

In its report titled *A Call for Action*, US CAP explains that, “A significant portion of allowances should be initially distributed free to capped entities and to economic sectors particularly disadvantaged by the secondary price effects of a cap...[to be]...phased out over a reasonable period of time.” (United States Climate Action Partnership, January 2007, p8. *A Call for Action* is available at www.us-cap.org .)

Environmental markets such as RGGI exist to achieve environmental goals – and to do so without an adverse impact on the economy. I can say simply that with 100% auctioning, Connecticut will neither achieve the full potential greenhouse gas emissions reductions nor protect the state’s economic interests.

100% Auction Allocation Provides 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 because there are no commercially available back-end controls, mandated reductions translate to ‘decreased generation’ which may affect system reliability.

Cap-and-trade systems are designed to benefit from disparities in the cost of abatement versus the market prices of allowance commodities. These programs encourage entities with a lower 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. SO₂ trading program is widely touted as a success is because it achieved its environmental goals much faster and cheaper than expected through trading. If Connecticut implements RGGI with full auctioning, it cannot and 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. SO₂ 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 potential abatement opportunities.

Market Manipulation

Excessive auctioning of allowances can also lead to market illiquidity and leave a program open to price manipulation. The U.S. SO₂ program incorporated an annual auction of approximately 2.5% of the total SO₂ allowance budget. Once the market began however, it became clear that auctioning in the US SO₂ market hindered market development rather than supported it. Trade volumes contract considerably before each auction, as market participants await the results. These episodes are also fertile ground for price manipulation. Time and again in the SO₂ program, we have seen expectation-led price distortions in the run-up to and aftermath of the SO₂ 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 SO₂ and NO_x 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.

It is worth reminding the Department that auctioning on the scale being discussed here in Connecticut and elsewhere in RGGI has never been attempted. In fact, the U.S. Acid Rain Program auctions more allowances than any other emissions cap-and-trade program, and this annual auction accounts for only 2.5% of the total allocation. Before Connecticut moves forward with implementation of its RGGI program, I urge the DEP to forego further consideration of 100% auctioning.

Thank you, again, for the opportunity to present my views.

Respectfully,

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