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The Regional Greenhouse Gas Initiative Conducting First Carbon Dioxide Allowance Auction

BY LISA K. RUSHTON AND JEFF ALLMON

Taking another key step toward becoming the first domestic mandatory program for the regulation of greenhouse gases, the Regional Greenhouse Gas Initiative ("**RGGI**") provided notice of its first carbon dioxide ("**CO_2**") allowance auction. RGGI is a cooperative effort by 10 states located in the mid-Atlantic and Northeast to regulate CO_2 emissions from fossil-fuel fired power plants through the use of a cap-and-trade regulatory regime. Six of the 10 participating states will offer CO_2 emission allowances for sale during the initial auction – Connecticut, Maine, Maryland, Massachusetts, Rhode Island and Vermont. The remaining four states – Delaware, New Hampshire, New Jersey, and New York – are expected to complete the rulemakings necessary to participate in the program and offer allowances during a second auction, scheduled for December 2008.

- For the first time, power plants in 10 northeastern states will have to pay for the right to emit CO_2.
- Regulators have created sufficient CO_2 emission allowances to accommodate expected power plant operations, and, in all 10 states participating in this program, all the allowances are being auctioned (i.e., none are being awarded to power plants).
- While only power plants have to hold CO_2 emission allowances, nothing prevents parties that do not operate power plants, including those speculating on future price increases, from participating in the CO_2 auctions, provide they timely register and fulfill other administrative requirements.
- Several aspects of the RGGI program are intended to prevent manipulation and market-volatility from driving the price of CO2 allowances sky high: No single bidder can acquire more than 25 percent of auctioned allowances at a single auction. Power plants can satisfy up to 3.3 percent of their allowance requirement through "offsetting" projects. And, if the price of allowances exceeds $7 or $10 per ton, power plants can use offsetting to accommodate an additional 5 or 10 percent of their allowance requirement and the scope of authorized offset projects expands.

RGGI's first auction will take place September 25, 2008, between 9 a.m. and noon (EST) on an internet-based platform (see http://www.rggi.org/auctions/index.html). At that time, 12,565,387 CO_2 emission allowances will be made available, with additional allowances available for purchase during the second auction in December. Starting January 1, 2009, regulated power generators located in participating states will be required to hold sufficient CO_2 emission allowances to account for their actual emissions. In order to participate in the auction, bidders must submit a notice of intent to bid, a completed application, and a certification of financial security to RGGI, Inc. by 5 p.m. (EST), August 8, 2008. Additionally, bidders must create an account with the RGGI allowance tracking system.

RGGI Program Overview

RGGI began in April 2003, when New York's governor George Pataki sent letters to the 11 governors from Maine to Maryland, inviting the states to participate in discussions for the development of a regional cap-and-trade program covering CO_2 emissions from power plants. On December 20, 2005, seven states announced an agreement to implement the regional initiative, outlined in a Memorandum of Understanding that was signed by each participating state. On August 15, 2006 the participating states issued a draft Model Rule for the program, which was finalized on January 5, 2007, and provides a guideline for individual states to implement the regional CO_2 Budget Trading Program. It is not a binding document, but rather a model for effective and consistent state regulation among the participating states.

The goal of RGGI is to lower carbon emissions from in the region to 10 percent below 2005 levels by 2019. The regional cap-and-trade program functions to provide each RGGI member-state an annual CO_2 emissions budget; by which each "allowance" distributed by the states will constitute one ton of CO_2 from a state's annual budget. The regional emissions cap and state budgets were established and allocated based on historic emission levels. The RGGI program requires that a minimum of 25 percent of all allowances allocated must be used for consumer benefit and strategic energy projects in order to minimize energy price increases and provide funding for the development of renewable resources. Beyond this commitment, participating states are free to allocate or auction their remaining budgets as they deem appropriate. However, presently all states participating in RGGI have either proposed or established regulations mandating the auction of 100 percent of the allowances available for distribution.

Between 2009 and 2014, participating states will stabilize CO_2 emissions from power plants. Thereafter, state budgets will be reduced by 2.5 percent annually through 2018. RGGI's initial total budget for CO_2 emissions for the 10 participating states is 188 million tons per year. Thus, by 2019, annual regional emissions will be reduced to 169 million tons.

Compliance

Regulated entities under the CO_2 Budget Trading Program must obtain a budget permit and hold sufficient CO_2 emission allowances—representing a limited authorization to emit one ton of CO_2—to account for their actual emissions of carbon during a three-year compliance period. The permit requirements will vary between states, but in all cases the regulatory authorities are required to issue operating permits only after approving a facility's permit application and Emissions Monitoring Plan (described below). Upon acquisition via auction or transfer, CO_2 allowances may be held and used for compliance, banked for future compliance with the program, or freely traded among regulated and non-regulated entities; achieving, at least in principle, a more efficient reduction in overall emissions from the range of regulated sources.

Regulated entities may purchase allowances for compliance in any of the RGGI states during the auction, even if the state in which it operates is not prepared to offer allowances at this time. Further, non-regulated entities are free to participate in the auction and may trade emission allowances as they see fit. For instance, by the end of August, the New York Mercantile Exchange ("**Nymex**") intends to introduce a RGGI allowance futures contract and an options contract for trading. These contracts will allow market participants to hedge price risk ahead of the upcoming auction. The futures contract will be available for trading on the Chicago Mercantile Exchange's Globex electronic trading platform, while the options contract will trade on the Nymex trading floor.

Emission Monitoring Plans

Emission Monitoring Plans required for all regulated entities must contain information about the facility's energy output and emissions monitoring procedures. The RGGI Model Rule specifies that certified Continuous Emissions Monitoring Systems ("**CEMS**") are required to measure and record emissions and energy output data by means of an approved automated Data Acquisition and Handling System ("**DAHS**"). CEMS are the standard equipment used to monitor emissions as mandated by federal rule. The CO_2 emissions monitor and automated DAHS must provide a "permanent, continuous record of CO_2 emissions." And, permanent records must be made and kept detailing emissions-stack flow rate, moisture, O_2, and CO_2 concentration. Regulated entities must submit these records to the regulating authority to assure compliance. Additionally, certain states may require independent audits of the regulated entities.

Compliance Cost Relief

RGGI contains various avenues to mitigate potential compliance costs. First, emission offset allowances, which are acquired from entities developing projects outside the power generation sector that reduce or sequester greenhouse gases in the United States, may be used by regulated entities to satisfy up to 3.3 percent of a unit's total compliance obligation. Second, when the average price of a CO_2 allowance reaches or exceeds $7 per ton (i.e. a "**Stage-One Trigger Event**"), regulated entities may use offsets to satisfy up to 5 percent of their compliance obligation. Finally, in the event the average cost of a CO_2 allowance meets or exceeds $10 per ton (i.e. a "**Stage-Two Trigger Event**"), power generators may (i) employ offsets for up to 10 percent of compliance obligations, (ii) extend compliance periods for an additional year, and (iii) acquire offsets developed pursuant to any mandatory carbon constraining program outside the United States or certified under to the United Nations Framework Convention on Climate Change.

Auction Details

Auction rules establish a cap on the total number of allowances that any single bidder may purchase in an auction, currently equivalent to 25 percent of the allowances offered for sale in a single auction. Upon the participating states approval of the auction outcome and upon payment in full by successful bidders, each state shall transfer the corresponding CO_2 allowances to each successful bidder's applicable account in a CO_2 allowance tracking system. States will retain full regulatory authority for transferring allowances from their respective state accounts to winning bidders, contingent on approval of auction results and financial settlement. Within a reasonable time period following each auction, the participating states shall publish, on the RGGI auction website, the auction clearing price and the total amount of allowances sold in such auction.

The September auction will offer allowances in 1,000 unit lots under a single-round format; accepting sealed bids based upon a uniform reserve-price of $1.86 per ton. In this respect, bids will be ordered from highest to lowest. The highest ordered bids will be cleared out, awarding those bidders allowances, until all allowances have been awarded—establishing a clearing price at the lowest bid figure awarded any allowances. While consistency among auction formats was the stated goal of RGGI member-states, flexibility has been retained to transition to a multiple-round, ascending-price auction format if necessary to address changing market conditions.

A reserve price of $1.86 per allowance will apply to the first auction. After the first auction, a reserve price will be in effect that is the higher of $1.86 per allowance, as adjusted annually from 2009 onward based on the Consumer Price Index, or 80-percent of the current market price of the particular RGGI allowance vintage being auctioned. A reserve price based on the current market price will only be used if representatives from participating states determine that there is sufficient, reliable market data available to establish a valid market price. The reserve price will be made known to prospective auction participants prior to each auction. Any unsold allowances will be made available for sale in future auctions in which a reserve price based on the current market price is being used. In 2012, as part of the first program review envisioned in the December 2005 RGGI Memorandum of Understanding, a decision will be made by the participating states as to whether to retire any unsold allowances from the first compliance period, or to offer these allowances for sale in subsequent auctions during the second compliance period.

Conclusion

With the pending deadline for submitting application materials to RGGI one week away, there is still plenty of time for materials to be prepared in advance of this deadline. Participants in this first-ever domestic auction of CO_2 allowances will play a crucial role in establishing the market conditions that will dictate the regulatory environment for carbon in the coming years within the United States. Early participation is, thus, advisable.

The next RGGI auction will be held in December of this year. For questions regarding the RGGI regulations please contact Paul Hastings.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Washington, DC

Lisa K. Rushton
202-551-1786
lisarushton@paulhastings.com

Thomas R. Mounteer
202-551-1775
tommounteer@paulhastings.com

Charles A. Patrizia
202-551-1710
charlespatrizia@paulhastings.com

Jeff Allmon
202-551-1709
jeffreyallmon@paulhastings.com

San Francisco

Deborah J. Schmall
415-856-7005
deborahschmall@paulhastings.com

Peter H. Weiner
415-856-7010
peterweiner@paulhastings.com

Zachary R. Walton
415-856-7076
zacharywalton@paulhastings.com

New York

David J. Freeman
212-318-6555
davidfreeman@paulhastings.com