

Carbon Finance

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Under the hammer

With the inaugural auction of US carbon allowances looming, Gloria Gonzalez looks at how the market is preparing for the kick-off of the country's first mandatory carbon dioxide cap-and-trade programme

Mounting anticipation ahead of the first auction of carbon dioxide (CO₂) allowances in the US could prove to be anti-climactic, with utilities likely to take advantage of a three-year compliance window to wait and see how the market develops. The auction marks the kick-off of the first attempt to establish a mandatory cap-and-trade programme targeting CO₂ emissions in the US.

After years of development, the Regional Greenhouse Gas Initiative (RGGI) will take a major step forward with its inaugural allowance auction on 25 September, when 12.6 million CO₂ allowances will be offered to the market. RGGI aims to control CO₂ emissions from power plants in the states of Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island and Vermont. From January 2009, the 10 states plan to cap emissions at 188 million short tons (171 million tonnes) of CO₂. That cap is fixed until 2014, and then declines by 2.5% each year until 2019.

"Kudos to all the states for getting this going," says Wiley Barbour, director of Environmental Resources Trust, a non-profit organisation in Rosslyn, Virginia which promotes the use of the market to protect and improve the environment. "There were times along the way where we had our doubts."

RGGI allowances have already begun to trade in the forward market, but volumes have been thin and mostly driven by speculators as compliance buyers await the auction. The RGGI market will operate in a similar fashion to the European carbon market – trading forward contracts for the future delivery of emissions permits, known as Regional Greenhouse Gas Allowances (RGAs). Each allowance represents one ton of CO₂. Exchanges have also got in on the act, with both the New York Mercantile Exchange and the Chicago Climate Futures Exchange launching RGA futures last month (see [Nymex, CCFE to list first US mandatory allowances](#)).

Activity involving compliance-mandated utilities has been muted in pre-auction trading, characterised by small volumes clearing in the December 2009 RGA contract, says Adam Raphaely, a broker on the environmental products desk at TFS Energy in New

York. "I would say there's been little significant activity in the run up to the first auction," he says.

"I don't see a highly liquid secondary market developing for at least six to nine months," adds Laurie Gage, a New York-based renewable energy and greenhouse gas (GHG) credit broker at CantorCO2e.

Prices have averaged \$5–5.50 per ton of CO₂ although they have fallen as low as \$3/t, which may give an indication of the starting prices in the first auction, says Lisa Rushton, a partner in the environmental practice group of the real estate division of law firm Paul Hastings. "Realistically, we should expect a very modest price for the initial carbon allowances that are traded," she says. The auction's reserve price is set at \$1.86/t, offering an artificial price floor to the market. The reserve price for future auctions will be set at either \$1.86/t, adjusted annually for inflation, or 80% of the market price for the vintage being auctioned.

Numerous factors are contributing to a cautious approach by utilities, including how to respond to a 100% auction market – a first for a US emissions programme.

"They've never had to devise a strategy around buying allowances in an auction before," Gage says. "They've always been able to rely on a portion of allowances being provided to them for free. Nobody really knows what the market is going to look like."

There is no real urgency for companies with compliance requirements to participate in the first auction as they have three years to comply with the RGGI mandate. "I do not expect we'll see 100% participation by utilities or anything close to that," Rushton says. "Since there is a three-year period of compliance, they will wait to see what happens with the market."

Due to the length of the compliance period, Public Service of New Hampshire (PSNH), the state's largest electric utility, is not saying whether it will be a buyer in the first auction. But the company will receive a yet-to-be-determined number of allowances as a "reward" for steps it has already taken to reduce carbon emissions, including converting a 50MW coal burner to a wood burner, says Martin Murray, senior corporate news representative for the utility, a subsidiary of Northeast Utilities based in Manchester, New Hampshire. Under the state's RGGI legislation, early reduction allowances can be provided to affected emitters for eligible projects undertaken to reduce CO₂ emissions in 2006 through 2008.

Atlanta-based utility Mirant says it expects to emit about 15.8 million tons of CO₂ from its Maryland, Massachusetts and New York facilities in 2009 and estimates its carbon credit costs will be \$111 million for the year. Mirant sees itself as both a buyer and a seller and will be participating in the first auction, says Misty Allen, director of external affairs for Mirant Mid-Atlantic in Landover, Maryland.

National Grid has completed the prequalification process, but has not yet decided whether it will participate in the first auction, says John Schroeder, director of electric supply for the utility based in Hicksville, New York.

The energy company has a "very aggressive plan" to reduce GHG emissions by 80% by 2050 and participating in RGGI "fits right in with that corporate plan," adds Robert Teetz, director of environmental management. "The key challenge will be trying to implement measures to reduce our emissions at the same time as trying to sustain our business

and sell our product,” he says. “It’s a very ambitious goal to reduce emissions at the same time [that] energy usage is expected to increase.”

But despite great enthusiasm for RGGI, there are numerous flaws in the system, experts say. While the significant participation of 10 states – including New York, one of the country’s largest emitters – and the transparency of the system are to be hailed, the high cap, omission of industrial and agricultural emitters, short ton trading that is somewhat incompatible with international markets (which trade in metric tons) and limiting the scope to CO₂ rather than all GHGs are critical design flaws, Rushton says. “With a market with a high cap, it just doesn’t drive the price up,” she adds. This risks no reductions being made as a result of the programme.

In comparison, the Western Climate Initiative – encompassing seven states and four Canadian provinces, including the easterly Quebec which borders RGGI member states – will have a broader reach and a higher cap. Meanwhile, a federal cap-and-trade system, with the support of both US presidential candidates and likely to become a reality in the future, will increase targets, creating more demand for allowances. “RGGI is a fabulous start, but somewhat conservative,” Rushton says.

And Steve Fine, a Virginia-based vice-president with consultancy ICF International, recently told participants in a *Carbon Finance* webinar on carbon prices that there is a risk of RGGI being oversupplied in the early years, “reminiscent of Phase I of the EU Emissions Trading Scheme”. In the European programme, this oversupply saw prices fall dramatically from around €30/tonne (\$42.50/t) to just €0.01/t by the time the phase ended.

Environmental Resources Trust would have preferred a tighter cap, but recognises that the RGGI secretariat is developing the system in a practical manner, Barbour says. “It is what it is, and it does start to move the ball forward, but I would have loved to have seen a more stringent target embraced,” he says.

However, whether RGGI strikes the right balance on its targets and the use of offsets remains to be seen, Barbour adds. For CO₂ offset allowances, the number that can be used for compliance is limited to 3.3% of the company’s emissions budget, rising when the RGA price passes \$7/t to 5% and then to 10% at \$10/t.

“I think it’s a little early to tell in RGGI what the demand will be for offsets, but what you’ve got in RGGI is an extremely sparse use of offsets,” Barbour says. By comparison, in the current trading period of the EU Emissions Trading Scheme, the region’s use of offsets is an average of 13%.

A key risk of the programme is the possibility of ‘emissions leakage’ outside the RGGI territory, a concern raised by several observers. Leakage refers to the ‘transfer’ of CO₂ emissions from a carbon-constrained region to one with no, or slack, caps. “It will be interesting to see what happens to emissions of carbon in neighbouring states,” PSNH’s Murray says. Notably in Pennsylvania, a coal-heavy state, which has opted not to participate in RGGI, despite being geographically in the middle of the region. Regardless of any flaws or future problems, market consensus is that RGGI is a positive step forward in the effort to reduce CO₂ emissions.

“This is exactly the type of strategy that is cost-effective and proven to work,” Barbour says. “The fundamentals are great and I can’t agree more with what they’re trying to accomplish. I hope it works well.”