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Regional Greenhouse Gas Initiative (RGGI): 2008 Update

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TEN NORTHEASTERN STATES have begun implementing a program to control and reduce the emission of greenhouse gases.¹ This Regional Greenhouse Gas Initiative ("RGGI" or the "Initiative") is similar in many aspects to the schemes developed pursuant to the Kyoto Protocol. RGGI will cap CO₂ emissions from electric power plants, allow for trading of allowances, and create a mechanism for fostering other projects that will offset CO₂ emissions to create additional allowances. The ratifying states are Connecticut, Delaware, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont and Maryland.

RGGI is designed to be a first step, impacting limited sources of carbon dioxide emissions, with the hope that the experience gained from this program will allow for further expansions going forward. RGGI will initially apply only to electric generating power plants larger than 25 megawatts, excluding biomass facilities (such as wood waste, energy-from-waste and other such facilities). The RGGI participating states agreed to a level of carbon dioxide emissions that will be allowed in each state. This standard is initially set at a level roughly equal to the actual average tons of carbon dioxide emitted annually from these plants during 2000 through 2004.²

Each allowance grants the right to emit a ton of carbon dioxide. Each participating state will be assigned a fixed number of these emission allowances. A state can allocate only up to 75% of a plant's average yearly emissions.³

At least 25% of a state's emission allowances are to be allocated for public benefit purposes. This means that these allowances will be distributed in a way that is to support energy conservation, fund the RGGI program itself, foster renewable energy, mitigate ratepayer impacts, or similar objectives. Most likely, these allowances will be auctioned and the proceeds utilized to fund various types of these activities. Some allowances may also be held in reserve for new power plants.

Power plants subject to these requirements will need to demonstrate that two months after the end of each applicable three-year compliance period, they hold sufficient carbon allowances to match their carbon emissions.

In other words, a power plant will have to accomplish some combination of either: (a) buying allowances either through a state auction or from other plants who do not need all of their credits, or from third parties who otherwise have acquired emission allowances; or (b) reducing emissions so that the plant does not need additional allowances.

RGGI UPDATE

In addition, power plants and other unrelated parties can "create" new carbon allowances (called "offsets") by undertaking verified and accredited projects that reduce the release of carbon dioxide into the atmosphere. There are limits to the number of these "offset" allowances that can be utilized by a power plant to meet its emissions cap, so as to avoid the creation of too many allowances.

A word about offsets. Offsets are, for the most part, not renewable energy projects.⁴ Offsets are projects that in and of themselves cause the amount of carbon dioxide being released into the atmosphere to be reduced. At the moment, these include only a few specific projects, such as capturing landfill gas that otherwise would be emitted into the atmosphere, eliminating leaks in natural gas distribution systems and propane systems, reducing methane from farming operations, and certain forest plantings.

Renewable energy projects such as wind turbines do not create carbon offsets because they do not directly result in a reduction of carbon that would be emitted into the atmosphere. Obviously, a wind turbine can offset electricity that would otherwise be generated from a carbon-emitting power plant, but that is only an indirect result.

The effect, if it were to be undertaken by the owner of a coal-fired plant that needs to acquire carbon allowances, would simply be to reduce the hours the coal plant is operating and reduce the number of carbon allowances that this plant would have to acquire, but the wind turbine does not create new allowances that can be traded.

The goal of the offset program is to create allowances that can be freely traded regardless of the source - each state's allowances should be tradable in any other state, and allowances created through the offset program will be freely tradable across states that are signatories to RGGI and interchangeable with other carbon allowances. Offset allowances can also be created from projects in non-RGGI

states that have agreed to enforce certain requirements.

The general terms of RGGI are reflected in a Memorandum of Understanding (MOU) executed by the various state governors. Model regulations were adopted in the summer of 2006. Each state has adopted these uniform rules. Obviously, it is critical that there be sufficient uniformity between the states such that allowances, and especially offsets that will be certified and created in each individual state, will be freely tradable. The first auction was held in September 2008. Future auctions will be held approximately every quarter. The first auction yielded an auction price of \$3.07 per allowance, and bids were received for four times the number of allowances available. A reserve price of \$1.86 was established, which can be raised but will not be reduced.

RGGI will take effect in 2009. The level of carbon emission allocations for each of the states will be at a stable level through 2015. Between 2015 and 2020, a 10% reduction in allowance (emissions) will be imposed.

There are various trigger mechanisms in the Initiative that are designed to relax restrictions on the use of allowances created from offset projects if the prices of the allowances exceed certain levels (and thereby result in too great an increase in electric prices).

Most of the RGGI states have announced that 100% of their allowances will be auctioned (instead of 75% being allocated to plants for free as allowed in the MOU). The states' economic analysis indicates that the value of even a "free" allowance would be included in the price at which electricity is sold, and might represent a windfall for power plants. With a 100% auction, the states will realize this windfall in revenue, which must be used for public benefits, primarily energy efficiency.

The economics underlying RGGI is the idea that power generated from plants that emit high levels of CO₂ will cost more and will be penalized in the marketplace, and therefore



less power will be generated from these plants. If that happens, CO₂ emissions will be reduced. However, the flip side is that consumers will pay more. At \$3.00 per allowance, the price of electricity in the region is likely to increase by approximately \$1.50 per month on average for a typical homeowner (or approximately \$0.015 per kw/hr).

Some studies have suggested that conservation and efficiency programs will offset the price effects of RGGI, but that remains to be seen. In addition, concerns have been raised with whether power from bordering, non-RGGI states will simply be imported into the region, thereby circumventing emission reductions, and simply penalizing in-region power producers.

COMPARISON TO KYOTO

In many ways, this scheme is similar to the Kyoto Protocol. However, under Kyoto, for industrialized countries, the initial emissions are capped at an estimated 1990 levels, and so there is an immediate reduction required. Also, the emission limits apply to many more industrial facilities in addition to power plants. Each country has allocated its assigned emission allowances to various industries in various percentages, reflecting that country's desire to cushion certain industries from potential price effects.

Kyoto also has several mechanisms for creating new carbon credits through projects that reduce carbon emissions in developing countries. In addition, several countries - most notably Russia and the Ukraine - have many excess Kyoto allowances that could be traded, because their carbon outputs in the early 1990s were significantly greater than they are today.

A market in the trading of government-issued allowances (EU allowances) is already in place. Allowances initially traded for as much as 20-30 Euros; however, at the end of the first reporting period it became clear that emissions had been

overestimated. Too many allowances were created, and thus the price collapsed, since allowances could not be carried over.

Many offset projects that will qualify for the production of carbon credits have been approved. The executive board created under UNFCCC (the governing framework for the Kyoto Protocol) is working hard to approve projects. The upside is that once a project methodology has been approved, it is publicly available and can be utilized by the general public to develop more projects based on the same methodology.

SUMMARY

The Regional Greenhouse Gas Initiative is a bold and pioneering step on the part of American entities in the absence of federal leadership. In its present form, it only impacts power generation facilities. However, the states involved intend this to be a starting point for regulation of all significant sources of carbon dioxide emissions.

In addition, it is no secret that it is hoped that RGGI will become a very broad-based program to fill a perceived vacuum regarding global warming on the federal level -- and to be a program that could transition easily into a nationwide regulatory scheme if there are policy shifts at that level.

Companies are well advised to become informed and involved in the early stages of this program, both to ensure that specific concerns are addressed in the details of the regulations that are being developed, and to be able to intelligently anticipate the program's consequences on the company's long-range plans. Details that are made a part of this regional program could well shape what ends up in any federal program that is enacted.

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1 California and other western states have enacted legislation that establishes requirements to reduce greenhouse gas emissions, but how it will be achieved has been left to state regulatory agencies. A cap and trade system is being discussed, and reductions will not be limited to electric generating facilities. In addition, several Congressional proposals that have been discussed resemble or complement RGGI, although others do not. Whether a federal initiative will negate RGGI or add to it is an issue that has yet to be worked out.

2 RGGI's carbon cap may be over allocated as a result of a shift away from oil use due to the high price of oil compared to natural gas.

3 The mechanism for a state's assigning emission allowances to a facility is to be determined on a state by state basis, and could be allocated free of charge, or auctioned, or distributed by using some other mechanism. However, most of the states have proposed to auction 100% of their allowances.

4 Except perhaps landfill gas recapture and methane capture at farms, which can include generation of electricity. However if electric production is included in an offset project the developer is obligated to assign any renewable energy credits or other credits to the state in order to obtain any RGGI offset credits.

BROWN RUDNICK'S CLIMATE AND ENERGY GROUP is an interdisciplinary team of attorneys and professionals who specialize in matters involving renewable energy project development and finance, emissions reduction schemes (e.g. NO_x, SO₂, RECs, RGGI, EU-ETS and Kyoto Protocol) and alternative energy sources.

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