

***** BEGINNING OF MESSAGE *****

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COMMENTS:

Comments of Morgan Stanley Capital Group Inc.
Midwestern Governors' Association
Greenhouse Gas Regulation Proposal
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Morgan Stanley Capital Group Inc. (MSCG) is pleased to have the opportunity to offer comments on the development of the Midwestern Governors Association (MGA) proposal for greenhouse gas regulation. Our interest in this topic stems from several perspectives. Morgan Stanley is the third largest seller of electricity in the United States and is active in electricity markets outside the US as well. We are also active participants in the emission markets in the US (SO₂ and NO_x) and in Europe (GHG). We are one of the founding investors in the NYMEX "Green Exchange", created for the trading of emission products, and are a provider of high quality offsets to customers and clients. In addition, we have been active participants in the development of the EU emissions trading scheme implementing the Kyoto protocol, the California efforts to implement Greenhouse Gas reductions in compliance with Assembly Bill (AB) 32, the Western Climate Initiative and RGGI. We hope the MGA will find our observations and recommendations constructive and helpful in developing its GHG reduction program, as well.

In terms of the overarching structure, MSCG believes that the MGA has chosen wisely in selecting an integrated multi-sector cap and trade program as the basic approach. Properly implemented, cap and trade ensures that the environmental goal is achieved at the least aggregate cost to society. Care must be taken, however, to avoid undermining the power of cap and trade with mandates, restrictions, caps, triggers, and other overrides. Doing so either undermines the environmental integrity of the cap, or increases costs to society without any incremental improvement to the environment. We will touch on this principle in more specific discussions below.

Distribution of Allowances

MSCG recommends distributing emission allowances 100% via auction. This ensures that all parties needing allowances will have equal chances to acquire them, and without putting any one at a competitive disadvantage. It also solves the "new entrant" problem which arises any time allowances are distributed to existing organizations within the footprint. Auctioning also ensures immediate market liquidity and price discovery. One lesson learned from the European Union Phase

One program is that many organizations that received direct distribution of allowances, did not, for whatever reason, offer surplus allowances for sale in the market. This caused the early days of the program to have illiquid markets, with more volatile prices than were justified by underlying conditions. It should be observed that allocations and auctions are not necessarily an “either/or” choice. MSCG recommends devising a method of returning auction proceeds to consumers to mitigate increased costs from GHG reduction measures. We note that former Clinton Administration Labor Secretary Robert Reich, in an op-ed article in the Wall Street Journal discussing the Lieberman-Warner bill, advocated sending an annual check to every citizen to distribute auction proceeds. More importantly, however, we note that whatever entities the MGA decides should receive allowance value, that value can (and should) be in the form of Auction Revenue Rights for allowances, rather than the underlying allowances themselves.

In Des Moines, one of the topics of discussion was how to come to agreement on the use of allowance value as part of a “model rule”. As stated above, we have our own recommendation on the best use of allocation value. However, we would observe that it is not important that the various jurisdictions be in sync regarding value allocation in order for a viable regional program to be developed. Distribution method, offset policy, linkage plan and a common administrative framework are all required for a regional program to work. It is entirely feasible, however, for a regional program to work without friction while the individual jurisdictions make different policy choices on value allocation. Therefore, we recommend that the Advisory Group committee not spend significant time trying to hammer out an agreement on this topic.

Offsets

MSCG strongly believes that inclusion of offsets in the MGA GHG program is very important. Offsets provide compliance flexibility. They act as de facto “safety valves” by providing price mitigation, thus eliminating the need for safety valves, price caps, floors or ceilings that would undermine the environmental integrity of the cap. Because of these important functions, we do not believe that the MGA should limit offsets by quantity or geography. Instead, the focus should be on quality. If the offset truly is real, additional, verifiable, and permanent, then submission of an offset for compliance purposes provides just as much benefit to the climate as submission of an allowance. Conversely, any restriction on use of such offsets will increase costs to society without any incremental reduction in greenhouse gas emissions.

In the draft document circulated by the Offsets subcommittee at the September 15 meeting in Des Moines, it was suggested that offsets be limited to jurisdictions that have as strict or stricter greenhouse gas emissions standards as the MGA. Jurisdictionally, all offsets come either from uncapped jurisdictions, or uncapped sectors in capped jurisdictions. Limiting accepted offsets to jurisdictions with strict GHG controls is an extreme restriction on offset sources, as such jurisdictions will be hard pressed to find projects that meet additionality standards. Those projects that can meet such standards are likely to be relatively high priced. Conversely, opportunities in uncapped jurisdictions are likely to be more common and therefore, on average, lower priced. Plus, they provide ways to engage more jurisdictions in the greenhouse gas reduction effort. For those reasons, we believe that limiting offsets

accepted to those from jurisdictions with strict GHG reduction programs is ill-advised.

In summation, a decision to prohibit usage of offsets that meet quality criteria is a decision to increase costs without any incremental decrease in greenhouse gas emissions.

Information Management

One issue that does not appear to have been discussed so far by the MGA is information management. It is axiomatic that markets run on information. Therefore, proper management of that information is crucial to smooth functioning of those markets. In the EU, significant market volatility and windfalls resulted from careless information management at the outset of the program. To avoid repeating the mistake, MGA should make the following a special focus:

- Ensure that any data or information about the program is released in a manner that ensures all stakeholders equal and simultaneous access. MSCG recommends studying the US Department of Energy (DOE) management of the weekly gas storage statistics as a model. In the EU, certain government officials did not appreciate the value of information, and carelessly leaked actual emissions data in talks given to small groups of people. The result of this error was significant windfalls to “insiders” at the expense of those who did not have advance access to the official statistics until formally released.
- Statistics should be collected and released relatively more than less frequently. In the EU, market perception on actual emissions was very far off the mark. When the first statistics on actual emissions were released, and proved to be much lower than expected, the price collapsed. A much more orderly market would have resulted if emissions statistics had been collected and released more frequently, rather than after a long period of time. MSCG suggests that quarterly collection and release would be a good target.
- Key statistics to be collected and released include:
 - Actual emissions
 - Allowances surrendered
 - Allowances distributed
 - Allowance distribution schedules
- Publicizing all administrative rules and schedules as far in advance as possible is desirable. MGA should think in terms of years rather than weeks.
- It is best if program parameters are not changed once the program is started. However, oversights and unanticipated issues probably make some adjustments inevitable. It is helpful if at least the criteria which will trigger changes are known and published in advance. When changes are to be made, significant advance notice is to be desired.

In summation, MGA should be cognizant of the market impacts of data, the need for frequent updating, and the stabilizing effects of minimizing changes and maximizing advance notice.

MSCG appreciates the chance to provide input to the MGA process. If there are any desires for follow-up discussions, please feel free to contact Steve Huhman, Vice President, at (914) 225-1592, or via e-mail at Steven.Huhman@morganstanley.com.

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