

SMOOTH SAILING FOR CALIFORNIA CAP-AND-TRADE

The launch of the California carbon market was watched with much scrutiny worldwide and in the United States. California is the 12th largest economy in the world, and its cap-and-trade program, with a cap over 400 million metric tonnes (Mt) in 2015, is the second largest compliance program in the world. California leaders are committed to setting an example for the nation and for the world of a tightly-run, ambitious emission trading program that would blaze the trail for other states and countries to follow. Given the state of disarray of the EU ETS and the Clean Development Mechanism (CDM), both vastly oversupplied, and the slow progress of climate policy at a U.S Federal level, the bar was high for California's new program. Almost a year after the launch, how is California doing?

Healthy allowances trading

One of the biggest worries for the California market was the potential lack of liquidity on the secondary market. With less than forty-five large emitters (over 500,000 t of annual emissions) in the first compliance period, the pool of potential market participants was fairly narrow, especially since a number of these emitters receive at least part of their allocation for free. Yet trading has proven healthy, with 377,480 t average daily volume year-to-date (YTD) for all vintages together, according to data from the InterContinental Exchange (ICE) and Evolution Markets. This adds up to 75 Mt YTD through mid-October, and if the trend continues, will make for just about 100 Mt traded on the secondary market in 2013. Options made up 35 percent of these transactions for all vintages. V13 allowances saw most activity - the most liquid contract, CCA Dec-13 V13 (2013 vintage allowances for delivery in December 2013) total volumes YTD of 46.5 Mt, over 60 percent of all CCA transactions. Yet traded volumes remain thin relative to the European market, where the average daily volume is closer to one percent of the cap.

Participation in the primary market has also been healthy. A total of 64.6 Mt V13

have been auctioned and sold so far, including state-owned and utility-consigned allowances. Future vintages were not so popular in the early auctions, and out of 68 Mt offered for sale over the course of the first four auctions, only 27 Mt have sold so far. But this figure does not reflect the fast growing interest in V15 and V16 allowances. Subscription rates for future vintages went from 46 percent at the February 2013 auction to 100 percent at the most recent auction, in mid-August. Pure play financial participants have stayed on the sidelines, buying only 7 percent of available allowances on average at past auctions. Taken together, emitters from the power sector – IOUs, municipal utilities, power merchants and power importers-dominate, with over half the participants coming from the power sector in any given auction. The oil industry and other industrial sectors contribute about 15 percent of participants each, out of an average 80 participants for each auction.

Offset market lags behind

The offset market has been slower to take off. Thirteen million tonnes Climate Reserve Tons (CRTs) issued since 2005 are eligible for conversion to ARB-eligible offsets, and only a fraction of these

traded in 2013 – the offset market size in 2013 was likely below 10 Mt in total. Market activity on the offset market has been held back due to a combination of factors. The buyer liability clause, whereby the regulator places invalidation risk on the purchaser of offsets rath-



er than the supplier, has caused some heartache to risk-averse buyers and produced plenty of friction on the market. The multiple contracts offered to address this issue have helped bring some uneasy buyers to the market, but have also contributed to a market fragmentation, whereby a given credit can fall under four different categories of contract depending on how liability is addressed. This fragmentation and the individual attention required from each contract

mean all offset transactions take place over-the-counter, and California offsets are unlikely to be exchange-traded anytime in the future.

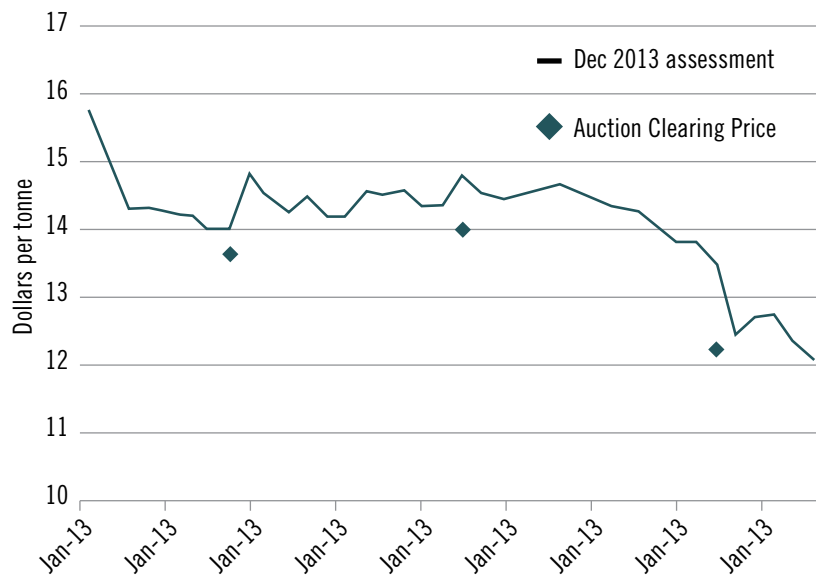
The other main holdup for the offset market was the conversion from ‘early credits’ to California Air Resources Board (ARB)-approved offset credits. ARB finally issued the first credits eligible for compliance in the California cap-and-trade program in late September: 350,000 t of early action, and another 350,000 t of ARB-compliant credits, all from ODS projects. Getting those projects through the formal approval and conversion process took no less than six months, but the market is hopeful that the floodgates are now open and more eligible credits will flow into the market over the coming months.

Prices

Prices as reported by the Intercontinental Exchange (ICE) have been remarkably stable over the first three quarters of trading in this first compliance year (see Figure 1.). The year opened at a high of USD15.75/t (Dec-13 V13), bolstered by the news that the San Onofre Nuclear Generating Station (SONGS) would stay shut down for good. The unexpected closure of California’s largest nuclear plant was expected to drive up emissions as carbon-free electricity would be replaced by gas-generated electricity. Yet prices quickly fell to USD14.50 and stayed range-bound between USD14 and USD15 through July 2013. The February auction cleared a few cents below, at USD13.62, while the May auction was more in-line with the secondary market prices, clearing at USD14.00.

Prices dropped a full dollar in August on the back of new inventory data released by ARB that showed historical 2011 emissions were significantly below forecast. In addition, the release of

FIGURE 1. PRICES FOR CALIFORNIA’S DEC-13 V13 CONTRACT. SOURCE: INTERCONTINENTAL EXCHANGE (ICE)



draft regulatory amendments providing for extended free allocation for industrial sectors also contributed to the bearish sentiment. The bear was further reinforced in the August auction, where prices dropped to USD12.22 a ton, also pulling secondary market prices down below the USD12.50/t mark. The low clearing price at the auction was as much a reflection of long-term fundamentals as it was of a cyclical phenomenon in oversupplied markets, where auctions late in the year see lower participation and lower clearing prices as a growing number of emitters have purchased the allowances they need for the calendar year. September saw even more of a fall as some market analysts announced they expected the market’s current over-allocation to continue into the third compliance period, providing little incentive for additional emission reductions.

California, overallocated - really?

Could California, one of the most ambitious emission reduction programs in the world, fall victim to the same affliction as its European and Northeastern counterparts? It is possible, but it is not

a done deal by any means. The reason California could indeed be overallocated and see prices close to the price floor through 2020 relates to the very ambition of its climate policy. California has implemented a range of overlapping, complementary policies that aim to reduce emissions from the power and transportation sectors in particular. The Renewable Portfolio Standards (RPS), which requires utilities to source 33 percent of their electricity from renewables sources by 2020, is indeed driving meaningful emission reductions through the state, as is the Emission Performance Standard (EPS), which essentially bars utilities from sourcing new electricity from coal (including out-of-state). In the transportation sector, the Low-Carbon Fuel Standard (LCFS) is starting to take a bite out of fuel emissions, while the long term effects of the GHG vehicle standards and incentives for zero-emissions vehicles (electric vehicles in particular) are also starting to be felt. If these policies, together with the dozens other less visible measures to reduce GHG, succeed at decarbonising the California economy, the cap may be more of a safety net than a constraint for years to come.

Yet over-allocation is not a done deal by any means. Tight offset supply, additional demand from California's trading partner, Quebec, and an economic revival could put upward pressure on prices through a combination of rising demand and rigid supply. The lack of readily available low-cost emission reductions means a short market could see rapidly rising prices down the road, albeit most likely kept in check by the price containment reserve.

Legal challenges mostly overcome

A year ago, the future of the California cap-and-trade program was mired with legal challenges and a certain amount of regulatory uncertainty, as the cap-and-trade regulation was due for multiple rounds of amendments, the latest of which is still ongoing. Yet over the course of twelve months, the air cleared significantly, as lawsuits were defeated and the path was cleared for the program to continue as planned. Generally, over the past five years since the publication of the first Scoping Plan in 2008, ARB has proven its resilience to legal challenges and its ability to stay on track. Market participants have signaled they trusted the program was here



to stay as prices and trading volumes for future vintages (V15 and V16) rose steadily over the year, including at the auctions, where bidders wrote a combined check for USD288 million in future vintage purchases. This indicates strong confidence that these permits will keep their value through the second compliance period.

What have we learned from this first year?

In many ways, ARB has been the star of the show for this first year. Two rounds of regulatory amendments, a new online registration and transaction system, auctions and other key market communications have generally been handled smoothly, avoiding any major shock to

the market and assuaging some participants' anxiety over the role that the air quality agency would play in the market. Yet ARB has also shown that it was not immune to one of the EU's main weaknesses from a market point of view – constantly updating rules, tweaking and fine-tuning regulations. While most of these tweaks were probably necessary, and many other (conflicting) changes are still called upon by stakeholders, the constant adjustments show that California may be more resilient to legal challenges than to political pressures.

That said public support for climate policy in California remains very high. As of July 2013, 75 percent of voters supported "immediate action by state and federal governments to arrest global warming and prepare for climate impacts," according to the Public Policy Institute of California. Governor Brown plans to run for re-election in the fall 2014 on a platform advocating further emission reductions for California through 2050, and the Air Resources Board is already starting to think about what the post-2020 cap will look like. California's cap-and-trade program looks like it is here to stay, and will remain a centerpiece of the Golden State's climate policy for years to come.



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