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Uncertainty Regarding Cap-and-Trade Regulation Reflected In Price Of GHG Emission Allowances Sold At First Auction

BY KEVIN POLONCARZ, MICHAEL S. BALSTER & BEN B. CARRIER

The California Air Resources Board (CARB) published the results of its first auction of greenhouse gas (GHG) emission allowances today, November 19, 2012. The publication of the auction results follows on the heels of last Wednesday's inaugural auction, a major milestone in CARB's development and implementation of a GHG cap-and-trade program that covers 85 percent of the California economy.

The auction sold all of the current vintage allowances at $10.09/allowance and 14% of the available future vintage allowances at $10.00/allowance. The allowance clearing price may have been depressed due to gathering litigation threats against the cap-and-trade program, which are described in more detail here. Thus, the auction clearing price published today may better reflect auction participants' views on whether the program will survive legal scrutiny, than the actual abatement costs needed to achieve California's GHG reduction goals or participants' estimate of future compliance costs.

November 2012 Auction

The November 14, 2012 auction sold two types of allowances: there were 23,126,110 current (vintage 2013) allowances and 39,450,000 future (vintage 2015) allowances available for purchase in multiples of 1,000 GHG allowances. Bids are awarded starting with the highest bid and proceeding downward, until all of the allowances were sold. Successful bidders will all receive the quantity of emission allowances for which they successfully bid at a uniform clearing price (i.e., the value of the lowest successful bid). If the auction is undersubscribed, as was the case for the auction of vintage 2015 allowances, then all bidders pay the auction reserve price of $10.00/allowance (i.e., the price floor).

Vintage 2013 Allowances

All of the current vintage allowances were contributed by the investor-owned utilities (IOUs) and publicly owned utilities (POUs), which were required to consign one-third of the allowances given to them by CARB for auction on their behalf. (The POUs could designate some portion in advance to keep for their own generating resources.) The utilities sold all of the allowances they consigned to auction—23,126,110 in all—at $10.09/allowance, netting a total of $233,342,449 for the utilities.

Deutsche Bank, the auction financial administrator, will return the proceeds from this auction directly to the utilities on December 10, 2012 and the revenue must be used for the benefit of ratepayers in

accordance with the direction of, in the case of the POUs, their respective governing boards and, for the IOUs, the California Public Utilities Commission (CPUC). The CPUC's ongoing Rulemaking No. 11-03-012 will prescribe how IOUs use their consigned allowance revenue for ratepayer relief. The recently enacted SB 1018 further limits how the IOUs' auction proceeds can be used by requiring that (1) no more than 15% of consigned IOU allowance revenue be used for clean energy and energy efficiency programs, and (2) the balance be "credited directly to the residential, small business, and emissions-intensive trade-exposed retail customers" of the IOUs.

No one entity amassed a concentration of vintage 2013 allowances in last week's auction. The Herfindahl–Hirschman Index (HHI)—a measure of the concentration of allowances purchased by winning bidders relative to the total sale of allowances in an auction—for the vintage 2013 allowance auction was 1133. While the HHI can range up to 10,000, representing 100% of allowances being purchased by a single bidder, a HHI index below 1,500 indicates an unconcentrated index.

Vintage 2015 Allowances

Unlike the current vintage allowances (provided by utilities), CARB provided all of the future vintage allowances available at the November 14th auction. CARB ultimately sold 5,576,000 vintage 2015 allowances or approximately 14 percent of the total allowances it made available. Because the vintage 2015 allowance auction was undersubscribed, the auction cleared at the auction reserve price of $10.00/allowance, netting $55,760,000 in funds for CARB. All proceeds from CARB's auction of allowances will be deposited in a new Greenhouse Gas Reduction Account within CARB's Air Pollution Control Fund until the revenue is appropriated in accordance with AB 1532. The LAO previously estimated that CARB's revenue from allowance auctions, which will be held quarterly after today's auction, will be in the range of $650 million to $3 billion in 2012-2013. Undersubscription of the future vintage allowances at this auction suggests that the lower end of the range may be more accurate. Like the 2013 vintage allowances, the HHI for the vintage 2015 allowance auction was below 1,500 (i.e., 1,485), which indicates an unconcentrated index.

Conclusion

Despite some uncertainty over the legal viability of the cap-and-trade program, CARB is moving full steam ahead. The first auction, while not producing the revenue projected by some accounts, ran smoothly and sold all of the current vintage allowances. Indeed, the fact that the auction cleared at less than one percent above the floor may have provided CARB some breathing room in response to claims that the Regulation will unreasonably drive up the cost of doing business in California. For these reasons, CARB may proclaim the first auction a success.

The low clearing price for both 2013 and 2015 allowances and undersubscription of the future auction both suggest that auction participation may have been chilled by litigation threats against the cap-and-trade program. On the eve of the auction, the California Chamber of Commerce filed a lawsuit challenging CARB's authority to auction allowances. *California Chamber of Commerce v. California Air Resources Board*, Cal. Super. Ct., No. 34-2012-80001313. This is the second lawsuit challenging certain aspects of the cap-and-trade program, as CARB is currently involved in litigation challenging its emissions offset protocols. *See Citizens Climate Lobby and Our Children's Earth Foundation v. CARB*, Cal. Super. Ct., No. CGC-12-5195544. However, the latter suit, which could invalidate the use of offsets within the program, should only exert upwards pressure on allowance prices. Greater downward pressure was more likely exerted by other, potentially more viable lawsuits that are expected to be filed against the Regulation.

With four more auctions for 2013 allowances scheduled next year, market participants should not rely too heavily on this auction's results to project their compliance costs during the first compliance period. Nor should they look to the results of the future auction of vintage 2015 allowances as indicative of their anticipated compliance costs during future periods, should CARB's program withstand legal scrutiny.

The next auction of allowances will be held on February 18, 2013.

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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:

San Francisco

Kevin Poloncarz
1.415.856.7029
kevinpoloncarz@paulhastings.com

Michael S. Balster
1.415.856.7216
michaelbalster@paulhastings.com

Ben B. Carrier
1.415.856.7094
bencarrier@paulhastings.com

Paul Hastings LLP www.paulhastings.com

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