

May 2013 California Cap-and-Trade Program Auction Shows Strengthening Carbon Market

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INTRODUCTION

On May 21, 2013, the California Air Resources Board (CARB) released the results of its most recent auction of allowances pursuant to the Cap-and-Trade Program Regulation, which was conducted on May 16, 2013. Significantly, the settlement price (the uniform price all successful bidders pay) for 2013 vintage allowances was \$14.00, marking a small, but nevertheless important, increase from the February 2013 auction. Additionally, there was increased participation among both covered entities and traders in the auction for 2016 vintage allowances, suggesting that market participants are becoming increasingly confident that CARB's Cap-and-Trade Program will not be halted by a judicial challenge. Together, these results send a strong signal that—whatever hesitations may have suppressed interest in the earlier auctions (the first auction in particular)—the market is coalescing around a clear price for allowances for the first compliance period (2013-2014) and reflecting participants' views that the Program will continue to be implemented well into the second compliance period (2015-2017).

BACKGROUND

The Cap-and-Trade Regulation establishes a declining cap on approximately 85 percent of total statewide greenhouse gas (GHG) emissions in order to achieve California's goal of reducing GHG emissions to 1990 levels by 2020. Entities subject to the cap (i.e., covered entities) must surrender to CARB compliance instruments equivalent to their GHG emissions. Compliance instruments include both allowances, which are freely allocated by CARB or obtained from auctions or the secondary market, and offset credits, which represent GHG emissions reductions achieved in sectors that are not subject to the cap.

Allowance auctions are held quarterly. Each auction includes a Current Auction of allowances from the current calendar year's allowance budget (e.g., 2013 vintage allowances are sold at the Current Auction in 2013) and an Advance Auction of allowances from the budget year three years subsequent to the current calendar year (e.g., 2016 vintage allowances are sold at the Advance Auction in 2013). Both covered entities and non-regulated entities can participate, but with different limits on the volume they can purchase. The May 2013 auction was the third auction of allowances under the Program thus far.

MAY 2013 AUCTION RESULTS: 2013 VINTAGE ALLOWANCES

All of the 2013 vintage allowances available for sale—14,522,048 in all—were sold at the settlement price per of \$14, well above the price floor of \$10.71. Perhaps more significantly, the settlement price for 2013 vintage allowances has continued to climb in each quarterly auction CARB has conducted, from \$10.09 in November 2012, to \$13.62 in February 2013, and now to \$14 in May 2013.

The 2013 vintage allowances sold at the May 2013 auction consisted of allowances consigned to auction by investor-owned utilities (IOUs) and publicly-owned utilities (POUs) as well as State-owned allowances. In all, IOUs consigned 10,839,537 allowances and thereby generated \$151,753,518 in revenue; POUs consigned 1,032,880 allowances and generated \$14,460,320 in revenue; and California sold 2,649,631 allowances and generated \$37,094,834 in revenue for the State's Greenhouse Gas Reduction Fund. Utilities must use the revenue they receive from consigned allowances for ratepayer relief, consistent with the direction of the California Public Utilities Commission for IOUs or each POU's governing board.

MAY 2013 AUCTION RESULTS: 2016 VINTAGE ALLOWANCES

The Advance Auction of 2016 vintage allowances again settled at the "reserve" or floor price of \$10.71. Of the 9,560,000 2016 vintage allowances available, 79% (or 7,515,000) sold, representing a significant increase from the 46% of available 2016 vintage allowances that were sold in February 2013. This suggests that the market for future vintage allowances is gaining momentum, which aligns with market analysis indicating that there will be much greater demand for GHG allowances starting in 2015 when the full scope of the Cap-and-Trade Program is implemented and fuels suppliers begin to be covered by the Program. With most analysts predicting substantially higher prices during the second (2015-2017) and third (2018-2020) compliance periods, settlement of the Advance Auction for the 2016 vintage allowances at the floor may represent a bargain and reveal some lingering uncertainties among market participants as to whether or not the Program will continue to be implemented beyond the near-term. All 2016 vintage allowances were State-owned, which means that the Advance Auction generated \$80,485,650 for California. In total, the auction of State-owned allowances has generated more than \$257 million for California, which is deposited into the Greenhouse Gas Reduction Fund.

California is circumscribed in how it can spend the revenue from the sale of State-owned allowances by, *inter alia*, Proposition 13 (i.e., California Constitution, Article XIII A, § 3), which requires two-thirds of the Legislature to approve any changes in state taxes enacted for the purpose of increasing revenues).¹ In particular, under case law interpreting Proposition 13, the auction revenues likely constitute "mitigation fee" revenues, which may only be used to mitigate GHG emissions or the harms caused by GHG emissions.² Notwithstanding this limitation, in the May Revision to the Governor's 2013-14 Budget, the Governor proposes to borrow \$500 million from the Greenhouse Gas Reduction Fund for a loan to the General Fund, which would not be repaid until after 2016-17.³ The Governor's proposed loan to the General Fund may indeed pose additional questions about the legality for the State's intended use of allowance auction revenues.⁴ Still, the Governor's announcement of his plans did little to dampen participation among market participants, who, through their robust participation in this allowance auction, have overwhelmingly signaled their belief that the Program will not be derailed by the pending lawsuits challenging the auction as a means of collecting revenue for the State.⁵

CONCLUSION

The GHG allowance market may be coalescing around a current vintage price in the \$14 range. Indeed, Thomson Reuters Point Carbon recently noted that the over-the-counter (OTC) assessed price for a California GHG allowance for December 2013 delivery is \$14.50. And, while the price for such future contracts climbed as high as \$14.90 on the InterContinental Exchange in anticipation of the release of the auction results, it quickly responded upon CARB's announcement to stabilize at \$14.50 again by the close of trading. While questions remain about the overall liquidity of these OTC and futures markets, the steadily rising settlement price for 2013 vintage allowances and the increasing participation among trading firms in the Advance Auction of 2016 vintage allowances signal that market participants are growing more confident that California's carbon market will continue to be implemented, legal challenges notwithstanding.



Paul Hastings Environmental and Energy lawyers are deeply involved in the development and implementation of California's Cap-and-Trade Program. If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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- ¹ AB 1532 further limits CARB's use of auction revenues for GHG mitigation projects pursuant to the Cap-and-Trade Auction Proceeds Investment Plan, which was developed by the Department of Finance and CARB, among other agencies, and finalized on May 14, 2013. Additionally SB 535 requires that the AB 1532 investment plan allocate at least 25% of the auction revenues to provide benefits to disadvantaged communities and at least 10% to fund projects located within disadvantaged communities.
 - ² See *Sinclair Paint Co. v. State Bd. of Equalization*, 15 Cal. 4th 866, 878 (1997) (mitigation fees (also called regulatory fees) are exempt from Proposition 13); see also Legislative Analyst's Office, the 2012-13 Budget: Cap-and-Trade Auction Revenues, at 4 (Feb. 16, 2012), available at: <http://www.lao.ca.gov/analysis/2012/resources/cap-and-trade-auction-revenues-021612.pdf> (stating that Cap-and-Trade auction revenues must be used to mitigate GHG emissions or the harms caused by GHG emissions in order to avoid any constitutional concerns under the *Sinclair Paint* test).
 - ³ This is a change from the Brown Administration's January 2013 proposal for the 2013-14 Budget, which assumed that \$500 million from the Greenhouse Gas Reduction Fund would be used to offset costs of GHG mitigation activities previously supported by the General Fund.
 - ⁴ The Legislature has stated that "California's Greenhouse Gas Cap-and-Trade program is a regulatory program authorized by AB 32, and the funds generated by the program are regulatory fees that conform with *Sinclair Paint Co.* . . . These regulatory fees are to be used for programs related to the reduction of greenhouse gases. In the event a court determines that any particular expenditure or use of the funds is an improper expenditure, then only that particular expenditure or use shall be enjoined and any monies improperly spent shall be reimbursed to the Greenhouse Gas Reduction Account to be used for any lawful purpose." See AB 1463, § 15.11(c). Presumably, a successful challenge to the Governor's loan from the Greenhouse Gas Reduction Fund would only require reversal of the decision to issue the loan and not the vacatur of the Regulation's provisions regarding the State's auctioning of allowances. Accordingly, although the Governor's decision is likely to be seized upon by litigants challenging CARB's authority to auction allowances, it may have little to no bearing on the viability of such litigants' claims. See note 5 *infra*.
 - ⁵ See Paul Hastings LLP Client Alert, "Uncertainty Regarding Cap-and-Trade Regulation Reflected In Price Of GHG Emission Allowances Sold At First Auction" (Nov. 19, 2012), available at: <http://www.paulhastings.com/publications-items/details/?id=6bc42a26-8aa5-6986-8b86-ff00008cffc3>. On April 16, 2013, the Pacific Legal Foundation filed a petition for a writ of mandate, seeking to invalidate the auction provisions of the Cap-and-Trade Regulation as a violation of Proposition 13. See *Morning Star Packing Company v. California Air Resources Board*, Cal. Super. Ct., No. 34-2013-80001464. Petitioners in *Morning Star Packing Company* subsequently filed a Notice of Related Case in both the *Morning Star Packing Company* case and *California Chamber of Commerce v. California Air Resources Board*, Cal. Super. Ct., No. 34-2012-80001313. On April 24, 2013, the Judge assigned to *California Chamber of Commerce* ordered the two cases related. Both cases will now be heard under the docket for *California Chamber of Commerce*, No. 34-2012-80001313.