

Comments of Morgan Stanley Capital Group Inc.
Market Design and Oversight
California Cap-and-Trade Market
April 30, 2009

Morgan Stanley Capital Group Inc. (MSCG) has reviewed the materials used in the March 23 public meeting to describe approaches and options for a California Cap-and-Trade market for greenhouse gas emissions allowances. We appreciate the opportunity to comment on certain key aspects of proposed system. If any party desires to have follow-up questions or discussions, please feel free to contact Steve Huhman, Vice President, at (914) 225-1592, or via e-mail at steven.huhman@morganstanley.com.

Auction Design

Financial Assurance:

MSCG support the inclusion of Financial Assurance requirements. Such requirements should be based on sound, well-tested evaluation methodologies. Credit and auction participation rights should be granted solely on such objective analysis. No differing criteria should be used for different classes of entities. Arguments are sometimes made that regulated utilities or government entities should be evaluated using different criteria than commercial entities. However, both recent and distant history is filled with examples of such entities going bankrupt, so requests for laxer standards for such entities are not justified.

Indirectly, appropriate financial assurance criteria impose a de facto position limit, as the amount of credit required to participate goes up with the size of the position sought. An entity trying to “corner the market” would find it very costly to provide the commensurate level of credit, and doing so during the pre-auction qualification process would alert the market monitor to closely analyze the activities of that particular participant.

Limits on Participation:

There should be no limit on who can participate in auctions based on entity type, or whether or not the participant has a compliance obligation. Arguments that non-compliance participants will “unnecessarily drive up prices” do not hold up to scrutiny. Prices at any given time will be determined by the market perception of supply and end-use demand. In a transparent program where total allowance supply over time is well publicized, the price will be driven by the collective market estimates of end-use demand. Dividing the available allowances up among more rather than fewer participants will not change this calculation.

To the extent auction participants without compliance obligations “overpay” for allowances, they will be subject to the “winner’s curse”, incurring a harsh price in terms of losses on resale, for such misjudgments. Furthermore, the auction participant without a compliance obligation has no incentive to bid in a manner that forces the price higher than it otherwise would be, as it presumably hopes to re-sell any allowances purchased for a profit. Quite the contrary, such an entity typically has an incentive to bid conservatively, hoping to pick up allowances “on the cheap”. Without a compliance obligation, failing to obtain any allowances at auction would rarely be a dire outcome, removing any incentive to bid “in desperation” in order to guarantee obtaining the desired allowances. Frequent auctions and viable secondary markets also work to undermine any “strategic bidding” schemes, since success or failure in any given auction does not have a material impact on one’s ability to obtain needed allowances.

Finally, maximizing the number of auction participants, and ultimately, allowance holders, serves the public purpose of minimizing opportunities for market power or market manipulation, and helps maximize liquidity and minimize volatility. There is another reason not to limit participation to entities with compliance obligations. Many entities with small compliance obligations are likely to prefer using the services of an intermediary to obtain their requirements, rather than develop the expertise, and undertake the bureaucratic activities needed to participate in auctions directly. Limiting participation would force every small entity to participate directly, which will not be cost-effective for many.

Information Release:

There is a discussion on how much information obtained by auction managers should be made public, and how much kept confidential. MSCG supports maximum market transparency consistent with protecting the legitimate proprietary interest of individual market participants. A good rule of thumb would be to publish “everything” in aggregate form, and publish “nothing” about individual market participants. After an auction, things like clearing price, number of successful and total bidders, quantity of unsold allowances (if any), etc. should be quickly released. However, bids of individual participants, allowances purchased, credit limits and similar data should remain confidential.

A related point in this area concerns data management generally. It is of critical importance that any and all data released be made available to all market participants simultaneously. In any market, “information is money”, and an informational advantage can provide an unfair competitive advantage and create a scandal. Just such an occurrence happened in the EU, when government carelessly disclosed preliminary emissions data during the first phase of the cap and trade program. The data release led to a price collapse, but some parties were aware of the situation well ahead of others and were therefore able to unload allowances at high prices on other uninformed market participants. We commend the process by which the US Department of Energy manages weekly release of natural gas storage statistics as an excellent template for management of data release.

Miscellaneous:

While we do not believe such restrictions are necessary for a well functioning market, MSCG does not oppose reasonable position limits, or similar restrictions on how much of any given auction event one party may purchase.

On balance, we believe relatively more frequent auctions are superior to relatively infrequent ones. While no one frequency should be viewed as “perfect”, quarterly seems to strike a good balance.

MSCG does not view the precise auction methodology as a crucial aspect of the design. Among the common options, we would mildly recommend a descending clock approach as providing the most transparency and the best price. The ability to see in “real time” what the competition is doing will tend to put some degree of psychological pressure on participants to not drop out too soon. Having made that observation, we view all of the commonly considered approaches to be workable.

Monitoring and Enforcement

MSCG recommends utilization of a professional, third-party market monitoring agency to evaluate both auctions and ongoing secondary market activity. This entity should issue regular, public reports on market function. Referrals on questionable activity of individual market participants should only be disclosed to regulators or other government bodies with statutory investigation and enforcement authority. Any enforcement activity by a regulatory entity should be conducted under the auspices of a strong due process regimen that guarantees the investigated party rights to review and rebut evidence, appeal a decision, etc.

With regard to penalties, we have no view on specific sanctions that should be employed. However, we do believe that sanctions should not be devised so as to simply present a financial alternative to compliance. Any failure to submit allowances for emissions should result in a continued obligation to eventually surrender the “missed” allowances, plus a financial penalty in addition.