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Comments for California on Revisions to the Cap-and-Trade Regulation

Submitted by:

Dallas Burtraw, Resources for the Future, 1616 P Street, Washington DC 20036 / burtraw@rff.org

These comments address the design and implementation of price and cost containment in the cap-and-trade program. I have two main suggestions for consideration by the Air Resources Board.

1. The market could be simplified if the sale of all allowances including those sold at price containment point prices was aligned with the regular auction.
2. “Emissions containment points” that apply a minimum price to a portion of the intended allowance supply, at a price above the auction price floor, could creating a more price-responsive allowance supply that would limit oversupply after 2020.

1. Mechanics of Sales from the New Post-2020 Reserve

The timing of sales of allowances at the price containment points could be aligned with the regular (quarterly) auctions to improve administration, transparency, and preclude the possibility of unintended outcomes associated with those allowance sales.

Currently, the sale of allowances from the Allowance Price Containment Reserve occurs separately in time from the quarterly allowance auction. This difference in timing introduces possibilities for temporal inconsistency. The Reserve comes into use if the demand for allowances in a quarterly auction is greater than the supply at a price containment point; however, the allowances are not made available for several weeks, during which time movement in the market might make their sale unnecessary.

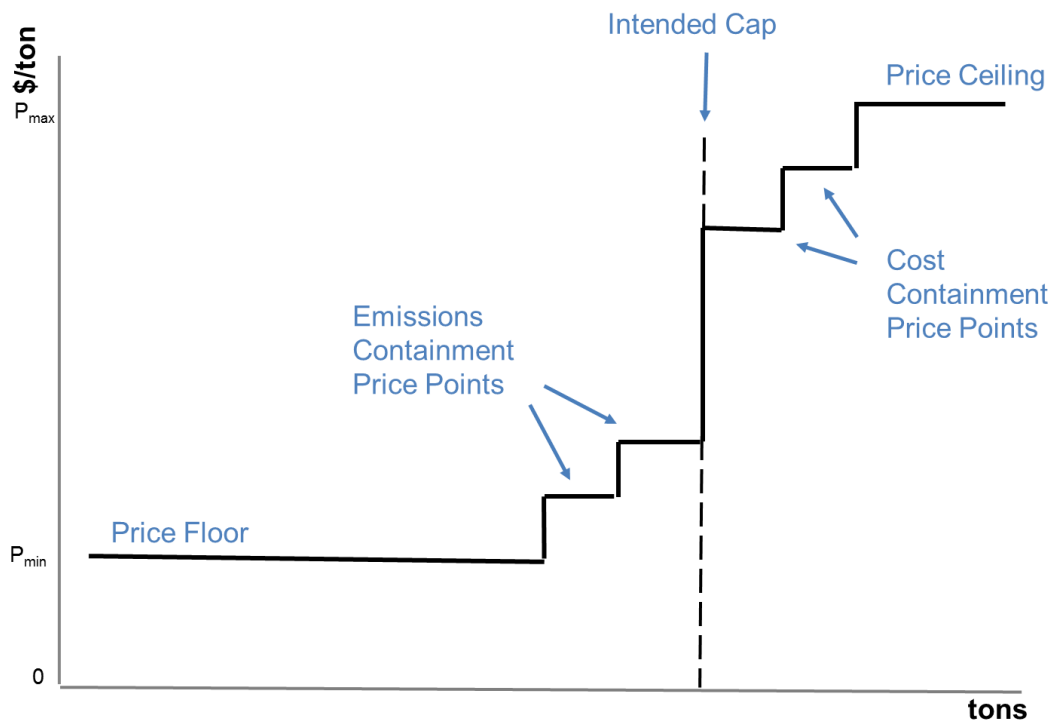
Allowances from the Reserve could be made available at specified price points as part of the regular auction. The tiers of the Allowance Reserve would bring additional allowances into the market by applying “reserve prices” set at the price containment points. If the auction price were to rise to these price points, the allowances from the Reserve would enter the market and be distributed without creating a distinction among the allowances that could be used for compliance, and without time for other market dynamics to intervene.

2. Emissions Containment Points Would Limit the Possibility for Over-Supply

There is an opportunity for the state to further improve the transparency and efficiency of the allowance market by making the supply of allowances responsive to the auction price. I apply the term “intended cap” to describe the number of allowances that would sell at an auction price above the price floor and below the allowance price containment reserve. However, over a wide range of auction outcomes, the supply does not respond to price, and all the allowances enter the market even when allowance demand and the auction price is relatively low This has contributed to the current perception of an allowance surplus.

A modification to this design could introduce price steps above the minimum auction price (i.e. the price floor). These price steps would incrementally constrict the sale of new allowances at low prices. For example, adding two price steps with prices above the floor would introduce a symmetric structure to the New Post 2020 Reserve that introduces allowances that are additional to the intended cap at cost containment price points. These price steps would each be associated with a specific quantity of allowances that would have individual “reserve prices” that apply in the regular auction. The auction would operate seamlessly. A picture of this allowance supply schedule appears below.

Figure: Price Points on the Allowance Supply Schedule



Many observers have expressed concern about the large volume of allowances that exist in private and public accounts, and some have suggested a one-time cancellation of allowances. While this may have merit, the introduction of price responsiveness in the supply of allowances would constrict supply in a gradual way in response to low prices. In contrast, a one-time cancellation of allowances might introduce transition issues.

These suggestions have a practical analogue in the operation of the Regional Greenhouse Gas Initiative, which provides a basis on which to improve the design of the California trading program. Thank you for the opportunity to share these views with the California Air Resources Board.

Sincerely,

Dallas Burtraw
 Darius Gaskins Senior Fellow / Resources for the Future