

White Paper**Unsold Allowances in the California Cap-and-Trade Program****Robert A. Wyman and Jean-Philippe Brisson****January 26, 2018****SUMMARY**

This white paper evaluates the extent to which the California Air Resources Board (“**ARB**”) may and should alter its treatment of unsold allowances under the regulations establishing California’s Cap-and-Trade Program (the “**Regulations**”).¹ Our preliminary conclusions are as follows:

- **Potential Adverse Market Impact of 25 Percent and 24 Month Rules.** The current Regulations limit the number of previously unsold allowances that ARB can offer for sale in a current auction to 25 percent of the allowances already designated for sale at that auction (the “**25 Percent Rule**”). This Rule slows the rate at which allowances can re-enter the market. Combined with a new rule requiring that unsold allowances must move to the Allowance Price Containment Reserve (“**APCR**”) after 24 months whether they are subsequently offered for sale or not (the “**24 Month Rule**”), the interplay between the two rules could result in removal of allowances from the market, even in the face of robust demand for allowances. Indeed, analysts have estimated that as many as 45 million allowances may ultimately be transferred from the Auction Holding Account directly to the APCR as a result of this interplay between the 25 Percent Rule and the 24 Month Rule.
- **ARB Discretion to Remove or Adjust the 25 Percent Rule.** To ensure adequate allowance supply for the duration of the post-2020 Cap-and-Trade Program, it is advisable for ARB to remove the 25 Percent Rule from the Regulations, or modify it to reduce its impact. ARB has the discretion to suspend or modify the 25 Percent Rule via regulation because it is not required, explicitly or implicitly, by any statute, including Assembly Bill (“**AB**”) 32 or AB 398.
- **Timing for Implementation of the 24 Month Rule.** The plain language of the 24 Month Rule suggests that the 24 month period would begin to run for *all* unsold allowances at the time the rule became effective, January 2018, such that no unsold allowances would be moved to the APCR until at least January 2020. ARB has suggested that it may take a contrary interpretation of the rule, however, that would result in allowances moving to the APCR more quickly. But ARB has discretion to follow the plain language of the Regulations and apply the later deadline to the existing pool of unsold allowances, avoiding a situation where such allowances move to the APCR even in the face of robust market demand.

¹ 17 Cal. Code Regs. §95800 *et. seq.*

ANALYSIS

This white paper addresses the treatment of unsold allowances in the Regulations under the 25 Percent Rule and 24 Month Rule described briefly above. The analysis presents the legal basis for both rules, and considers whether the interplay between the 25 Percent Rule and the new 24 Month Rule could artificially constrain the supply of allowances, and, if so, whether it would be possible and beneficial for ARB to modify the 25 Percent Rule or remove it from the Regulations. Our analysis concludes that ARB has discretion to revise the 25 Percent Rule and allow more allowances to be offered for sale at auction without running afoul of AB 398 or other legal requirements. As a policy matter, ARB should rescind or amend the 25 Percent Rule to avoid unnecessarily retiring unsold allowances.

I. SUBSTANCE AND ADOPTION OF THE 25 PERCENT RULE

Under §95911(f)(3) of the Regulations, state-owned allowances offered for sale at an auction but not purchased by any auction participant are kept in the “Auction Holding Account.” Pursuant to the same provision of the Regulation, ARB will re-auction such unsold allowances, but only after two consecutive auctions have cleared above the Auction Reserve Price. *Id.*

Under §95911(f)(3)(C) of the Regulations, the number of state-owned allowances that may be re-auctioned at a specific auction in the future may not exceed 25 percent of allowances already designated by ARB for sale in such future auction. This rule does not apply to previously unsold “consigned” allowances (*i.e.*, allowances allocated to, and sold at auction on behalf of, utilities), all of which are automatically re-offered for sale at each auction until sold. Previously unsold allowances that ARB does not offer for sale due to the 25 percent restriction remain in the Auction Holding Account for later auction.²

For example, if 50 million California-owned and California consignment allowances were offered for sale in an auction, and ARB has 100 million previously unsold California allowances in the Auction Holding Account, the maximum number of unsold California allowances eligible for re-designation would be 25 percent of 50 million, or 12.5 million. ARB would offer 62.5 million allowances for sale at the auction, and 87.5 million of the 100 million unsold allowances would remain in the Auction Holding Account. The quantity of previously unsold allowances or allowances offered for sale that originated from linked jurisdictions would not affect these figures.

ARB originally proposed the 25 Percent Rule in 2012, and the rule became effective on October 1, 2013. During that rulemaking, ARB explained that the purpose of the 25 Percent Rule is to “avoid another undersubscribed auction.”

An alternate approach to regulation of unsold allowances would be to relax the 25 Percent Rule in the event that the market demonstrates continued robust demand. For example, ARB could consider adopting a rule that increases the percentage of unsold allowances re-designated to auction by 5 percent for each subsequent auction that cleared the floor price,

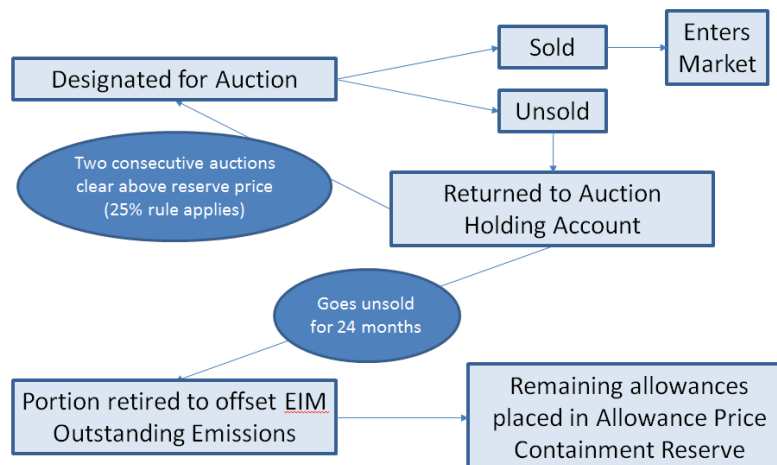
² Allowances designated for auction by linked jurisdictions are subject to those linked jurisdictions’ rules if left unsold.

starting from the current 25 percent limit. Tying the re-designation of unsold allowances more closely to auction performance would allow ARB to be more responsive to sustained demand for allowances, while still serving the original 25 Percent Rule’s purpose of preventing dilution of the market.

II. THE 24 MONTH RULE AND THE LIFECYCLE OF AN UNSOLD ALLOWANCE

ARB amended the Regulations in 2017 so that current vintage allowances that go unsold for 24 months will either be retired or placed in the APCR. Beginning January 1, 2018, ARB will retire current vintage allowances that have been designated for auction pursuant to §95911(f)(3) and remain unsold for more than 24 months to account for certain emissions associated with ARB’s Energy Imbalance Market (likely only a small portion of unsold allowances).³ Most allowances that go unsold for 24 months will be subject to the new §95911(g), which provides that beginning January 1, 2018, current vintage allowances that are designated for auction, remain unsold in the Auction Holding Account for 24 months, and are not retired in connection with the Energy Imbalance Market, will be transferred to the APCR. The following diagram demonstrates the application of the 24 Month Rule and the 25 Percent Rule described above.

Lifecycle of an Unsold Allowance (Current Vintage Auction)



According to ARB’s Initial Statement of Reasons (“**ISOR**”) for the rulemaking adopting the 24 Month Rule, starting in 2018 the new section 95911(g) is necessary to allow ARB to transfer unsold allowances to the APCR when the market is depressed for a long period of time. Staff views the new provision as a “potentially valuable way to improve cost containment provisions.” 2016 ISOR p. 220. In response to comments expressing concerns about how the 24 Month Rule could tighten the allowance market, ARB indicates in its Final Statement of Reasons

³ 17 Cal. Code Regs. §95852(b)(1)(D).

(“**FSOR**”) that transferring unsold allowances to the APCR will not reduce market supply or liquidity because those allowances are not on the market, as they have never left the Auction Holding Account. The same response also notes that the new 24 Month Rule does not actually remove allowances from the market because, “[t]hose allowances still would be made available for sale, but at the Reserve tier price.” 2017 FSOR p. 491.

III. AB 398

AB 398, passed into law on July 25, 2017, extends the Cap-and-Trade Program and directs ARB to make a number of changes to the Regulations. AB 398 directs ARB to implement the 24 Month Rule starting in 2021. ARB has not proposed any further amendments to comply with AB 398’s requirement, beyond the recently adopted 24 Month Rule.⁴ In contrast, AB 398 is silent with respect to the 25 Percent Rule. Accordingly, ARB is free to alter the 25 Percent Rule or delete it from the Regulations as they apply before or starting 2021.

The following table shows the regulatory requirements for both the 25 Percent Rule and the 24 Month Rule, the statutory provisions applicable to these rules, and ARB’s proposals for future rules.

Current Regulation (Effective October 1, 2017)	AB 398 Requirement	ARB Proposal
§95911(f)(3) provides that allowances designated for auction that remain unsold shall be kept in the Auction Holding Account for later auction. Unsold allowances will be re-designated for auction after two consecutive auctions have resulted in an auction settlement price above the Auction Reserve Price, provided that the number of allowances re-designated to a subsequent Current or Advance Auction may not exceed 25 percent of allowances already designated by ARB for that auction.	AB 398 does not address the 25 Percent Rule. ARB has the discretion to keep, rescind or amend the 25 Percent Rule for the period of time before and starting in 2021.	ARB has not proposed to revise the 25 Percent Rule or otherwise addressed it in its AB 398 workshops.

⁴ ARB Staff Presentation, “Cap-and-Trade Regulation Workshop,” (October 12, 2017), slide 21, available at https://www.arb.ca.gov/cc/capandtrade/meetings/20171012/ct_presentation_11oct2017.pdf.

Current Regulation (Effective October 1, 2017)	AB 398 Requirement	ARB Proposal
§95911(g) provides that beginning January 1, 2018, current vintage allowances that are designated for auction, remain unsold in the Auction Holding Account for 24 months, and are not retired to compensate for EIM Outstanding Emissions, will be transferred to the Allowance Price Containment Reserve.	38562(c)(2)(C): “Require that current vintage allowances designated by the state board for auction that remain unsold in the auction holding account for more than 24 months to be transferred to the allowance price containment reserve” after 2020.	No proposal for additional rulemaking beyond the recently adopted 24 Month Rule.

IV. POTENTIAL MARKET IMPACT OF ARB’S UNSOLD ALLOWANCE PROVISIONS

The combined effect of the 25 Percent Rule and the 24 Month Rule is that unsold allowances could potentially move to the Allowance Price Containment Reserve even if there is strong market demand for them. The 25 Percent Rule creates a bottleneck that restricts the ability of unsold allowances to enter the market. If a sufficient number of allowances go unsold, the 25 Percent Rule could create a backlog that takes more than 24 months to process. Any remaining allowances would then be sent to the APCR or retired, without ever being re-designated for auction. This would have the effect of artificially constraining allowance supply and potentially increasing compliance costs in the cap-and-trade program without creating any corresponding environmental benefit.

As an illustrative example, consider a situation where 100 million allowances have gone unsold in prior auctions, and the eight quarterly auctions scheduled for the next two years are each scheduled to offer 40 million current vintage allowances. Assuming these facts, operation of the 25 Percent Rule would allow 10 million additional allowances to be sold at auctions #3-#8 if auctions #1-#2 sell out. After eight sold out auctions, 40 million allowances would remain unsold and would move to the Allowance Price Containment Reserve. The following table demonstrates this scenario:

	Auction	Allowances originally designated for sale	Unsold allowances designated for sale	Unsold allowances remaining
24 Months	Auction #1	40,000,000	0	100,000,000
	Auction #2	40,000,000	0	100,000,000
	Auction #3	40,000,000	10,000,000	90,000,000
	Auction #4	40,000,000	10,000,000	80,000,000
	Auction #5	40,000,000	10,000,000	70,000,000
	Auction #6	40,000,000	10,000,000	60,000,000
	Auction #7	40,000,000	10,000,000	50,000,000
	Auction #8	40,000,000	10,000,000	40,000,000
Allowances moved to APCR				40,000,000

According to ARB, there were 104,704,896 unsold California-owned allowances as of the beginning of December 2017, all of which could potentially be subject to the 25 Percent Rule and the 24 Month Rule.⁵ Bloomberg New Energy Finance has estimated that as many as 45 million of these allowances may move to the APCR without being sold at auction, even though future auctions are expected to sell out.⁶ A scenario where any allowances moved to the APCR in the face of strong demand would unnecessarily increase compliance costs in the program, conflicting with the Legislature’s stated intent of meeting statewide GHG emission limits “in a manner that minimizes costs and maximizes benefits for California’s economy.”⁷

V. TIMING OF THE APPLICATION OF THE 24 MONTH RULE

Section 95911(g) indicates that, “[b]eginning January 1, 2018...current vintage allowances designated by ARB for auction...that remain unsold in the Auction Holding Account for more than 24 months will be transferred to the Reserve.” A plain reading of this section implies that the clock on the 24 Month Rule did not start ticking until January 1, 2018. Use of

⁵ Air Resources Board, “Guidance on Treatment of Unsold Allowances Following an Undersubscribed Auction,” (December 1, 2017), available at: https://www.arb.ca.gov/cc/capandtrade/guidance/guidance_unsold_allowances.pdf (“**Unsold Allowances Guidance**”) at 4.

⁶ Bloomberg New Energy Finance estimate is not publicly available.

⁷ California Health and Safety Code sec. 38501(h).

the word “[b]eginning” coupled with the present tense of the word “remain” (as opposed to, e.g., the perfect tense “have remained”) indicates that the earliest that such a 24 month period could begin is January 1, 2018. Accordingly, time already spent in the Auction Holding Account prior to January 1, 2018 should not count toward the 24 month limit, and no allowances should be moved to the Allowance Price Containment Reserve under Section 95911(g) prior to January 1, 2020.

ARB’s rulemaking documents are unclear as to when the 24 month clock begins to run for allowances that were unsold at auctions occurring prior to 2018. In its ISOR, ARB notes that “[b]eginning in 2018, any previously unsold allowances owned by the State that have been in ARB’s Auction Holding Account for 24 months would be transferred to the APCR.” 2016 ISOR at 17. The same document notes that the 24 Month Rule does not take effect until 2018. 2016 ISOR at 17, 220.

Notwithstanding the plain language of the regulation, ARB’s December 2017 guidance document on treatment of unsold allowances suggests that the 24 Month Rule applies retroactively to allowances that were unsold at auctions occurring prior to 2018. Specifically, in a section explaining the “recently approved regulatory amendments,” the guidance document provides an example indicating that, “if the 2,951,275 vintage 2016 allowances that went unsold at the February 2016 Joint Auction had remained unsold through and after the February 2018 Joint Auction, those allowances would be...moved to the Auction Price Containment Reserve.”⁸ This statement is merely hypothetical, since those allowances were re-designated for auction and sold in the November 2017 Joint Auction. In any event, ARB’s guidance document does not prevent ARB from only applying the 24 Month Rule to allowances that are unsold in auctions occurring from 2018 on; as ARB has noted on its guidance document webpage, “unlike the regulation itself this guidance does not have the force of law.”⁹

Until this ambiguity is clarified, the 24 Month Rule should be construed as only applying to allowances that go unsold in auctions occurring in 2018 and beyond. To interpret the 24 Month Rule otherwise would be to raise questions of whether the regulation impermissibly acts retroactively. As the California Supreme Court has observed, “The presumption of prospectivity . . . is broadly based on policy considerations involving fairness. Retroactive laws are generally disfavored because the parties affected have no notice of the new law affecting past conduct.” *Tapia v. Superior Court*, 53 Cal. 3d 282, 304–05 (1991). Accordingly, it is reasonable to assume the 24 Month Rule applies prospectively only.

⁸ Unsold Allowances Guidance at 5.

⁹ Air Resources Board, “Regulatory Guidance Document” (last accessed January 19, 2018), available at: <https://www.arb.ca.gov/cc/capandtrade/guidance/guidance.htm>.