Comments of the Western Power Trading Forum
To the California Air Resources Board
on Cost-Containment Mechanisms under the Cap and Trade Program

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The Western Power Trading Forum[1] (WPTF) appreciates the opportunity to provide input to the California Air Resources Board (ARB) on its consideration of options to contain costs under a greenhouse gas (GHG) cap and trade system. As we understand the approach proposed at the June 22nd workshop, ARB has proposed a 'soft' price collar which would utilize the supply of compliance instruments (allowances and offsets) to control prices, rather than a 'hard' price cap and would establish an auction reserve price to create a price floor.

WPTF maintains that good design of the cap and trade system is the best way to mitigate costs to California consumers. Specifically, broad sectoral coverage, multi-year rolling compliance periods, unlimited banking, linkage to other programs and use of offsets will increase market liquidity, expand opportunities for low-cost GHG reductions, and substantially reduce the risk of unacceptably high costs. None-the-less, we recognize that unanticipated factors could lead to excessively high compliance costs or other unintended consequences, such as electrical system reliability problems. We offer the following comments on the circumstances under which market intervention may be warranted and the appropriate response.

Identifying significant economic harm

The success of the cap and trade system will be dependent on providing a carbon price signal to incentivize changes in generator dispatch, and long-term investments in low-GHG technologies, including carbon sequestration. As a general rule, interference in the carbon market will distort this price signal and should therefore only be considered under extreme circumstances. In this regard, we note that AB32 itself establishes the appropriate conditions for market intervention: it authorizes the Governor to adjust the timing and level of GHG reductions in the event of "extraordinary circumstances, catastrophic events or the threat of significant economic harm".

As WPTF has previously stated, we support the establishment of a market advisory body to monitor market conditions, and to advise the Governor if intervention in the market is warranted. The cap and trade regulation should establish guidelines for this advisory body in identifying extreme economic conditions, but should avoid establishing an inflexible, prescriptive mandate. Allowances price should be one factor considered by the advisory body in identifying unacceptable consequences, but should not be used as automatic trigger. Rather, the advisory body should consider other indicators of anomalous market conditions, such as sudden, rapid and sustained price increases relative to a rolling average. Guidance should also require that cost-containment mechanisms should be limited to true damage control and should not be triggered by short-term price volatility.

[1] WPTF is a diverse organization comprising power marketers, generators, investment banks, public utilities and energy service providers, whose common interest is the development of competitive electricity markets in the West. WPTF has over 60 members participating in power markets within the WCI member states and provinces, as well as other markets across the United States.

Mechanism for increasing supply of compliance instruments

WPTF believes that an allowance reserve would be the preferred mechanism to increase the supply of allowance instruments in the event of extreme economic harm. However, we do not have a position on whether the allowance reserve should be sourced from current or future allowance budgets. We are strongly opposed to an approach that would relax the quantitative limit on use of offsets for compliance. The market uncertainty created by such an approach would make it exceedingly difficult for capped entities to plan for the use of offsets in their compliance portfolio, and would discourage investments in offset projects. WPTF also opposes authorization of entity-level borrowing as a mechanism to increase the supply of compliance instrument.

Mechanism for releasing additional compliance instruments

If ARB selects an allowance reserve as the mechanism to increase the supply of compliance instruments, then it will also need to determine the mechanism for releasing these allowances to the market. In WPTF's view, it is important to ensure that all capped entities have access to the allowances and that the carbon price signal is maintained and transparent. Auction of allowances would meet these objectives better than free allocation, or a 'window' approach. We also note that an auction of reserve allowances would alleviate the need to establish additional rules to prevent misuse of reserve allowances, such as prohibition on banking and resale of allowances within 30 days.

Price floor

While WPTF agrees with the importance of establishing clear price signals for long-term investments in GHG control technologies, we believe that these prices signals are best ensured through setting an appropriately tight cap – not by interfering in the market. For instance, it is well established that the European Emission Trading program was over-allocated in Phase I of the program. As a result of this lax cap, allowance prices collapsed in late 2006 and 2007. Allowances prices for Phase 2, which has a much tighter cap, have remained in the 20-30 Euro per metric ton range.[2]

While the economic analysis of California's cap and trade program is ongoing, the emission cap is more stringent than that of the EU ETS, and much more stringent than that of the Regional Greenhouse Gas Initiative in the eastern United States (where prices have remained low). Thus there is good reason to believe that allowance prices in the California program will be sufficiently high to incent investment in emission reductions, without imposition of an artificial price floor.

[2] European Climate Exchange, http://www.europeanclimateexchange.com/default_flash.asp