California ARB Implementation of AB32
Cap and Trade Rules
Comments of Morgan Stanley Capital Group
July 13, 2010

Morgan Stanley Capital Group Inc. (MSCG) is a wholesale power marketer that is also commercially involved in various aspects of businesses focused on reducing greenhouse gas emissions, especially those related to electric power generation. We are active in the Western Electricity Coordinating Council (WECC) market area in general, and in California in particular. As such, we have a strong interest in the implementation of AB32, and have been involved in the process of developing the implementing rules since the beginning. As that process moves into its final stages, we would like to take this opportunity to express our views on several of the remaining key issues still being discussed, as the ARB develops its final recommendations for rule adoption to its Board. For follow-up questions, discussions or clarifications, please contact Steve Huhman at (914) 225-1592, or via e-mail at Steven.Huhman@morganstanley.com.

Cost Collars

Because of concern over costs, "collars" have entered the conversation. Morgan Stanley does not believe that collars are consistent with environmental integrity, and strongly recommends against adoption of any such approach. Furthermore, the "floor" side of cost collars is counterproductive to the goal of cost containment.

MSCG does not believe that arguments that minimum prices are needed to stimulate transformative investments stand up to scrutiny. If market prices are too low to justify "transformative" investments, it can only be because the use of existing technology has achieved the desired reductions without such "transformative" technology. Thus, such investments would be wasted, and needlessly impose excess costs on consumers. Indeed, many advocates for emissions reduction regulations have argued that existing, cost-effective energy efficiency technologies can achieve the desired reductions by themselves, or at least the amount of reductions required in the early years. MSCG does not claim that they are either right or wrong. However, one of the key advantages of a cap and trade program is to let the market sort out which view is correct, thus achieving the desired reductions at the lowest possible cost. Use of a price floor would mean failing to take advantage of one of the major theoretical advantages of cap and trade.

Price ceilings present a different dilemma. Either the cap must be breached, or some sort of artificial allocation or rationing scheme must be devised for when the cap is hit. "Reserve" programs are really just price smoothing mechanisms. If the reserve is exhausted, then either the same dilemma is reached, or prices are allowed to resume the (presumed) upward rise. In any case, unless the parameters of the how the reserve will be used are kept secret (an approach we do not advise), the market will factor this

information into its pricing. Therefore, a reserve is not likely to provide much "cost containment" over any meaningful time period.

A related concept is the "trigger". For example, when allowance prices reach a specified level, the amount of offset credits allowed for compliance would be increased. In theory, this might moderate prices without violating environmental integrity. However, it requires that a significant pool of unutilized offset credits be available. In our view, this is unlikely. Offset development is a process which takes considerable lead time, and the supply will not be elastic over short time frames. Far better to avoid restrictions on the use of high-quality offsets in the first place. As we have repeatedly stated in prior commenting opportunities, we believe that unrestricted use of high-quality offsets is the best possible approach to cost containment.

If, against our recommendations, a cost collar is adopted, we strongly urge specifying price parameters explicitly in the final rule. Our understanding is that one option under consideration is a formulaic approach that would require inputs not currently known (e.g. actual 2010 emissions). We are concerned that under this type of formulaic approach, the uncertainty would act as an inhibitor to investment in emissions reducing activity, both by regulated emitters and offset project developers. From the perspective of someone that needs to make decisions about capital deployment, a "reasonably accurate" but precisely known collar is far better than a "theoretically superior" collar calculation methodology whose output cannot be reliably projected.

Imported Power

To date, there has been much discussion about regulations required for application to imported power, but with little definitive resolution. We believe the final rule issued at the end of the year needs to be specific with regards to the following issues:

- How will "specified" power be differentiated from "unspecified" power?
- What will be the "default" emissions factor assigned to unspecified power?
- Will there be one or multiple "default" emissions factors?

MSCG is not prepared at this time to make any definitive recommendations regarding the various approaches under discussion, but we may provide supplementary recommendations in the near future.

Offsets

MSCG's understanding is that, due to cost containment concerns, ARB is reconsidering its previous preliminary recommendation on offset limits. We have consistently argued throughout this rule development process that offsets should be limited only by quality, not by quantity or geography. We stand by this recommendation, and won't repeat the policy arguments supporting it, which have been well developed in prior comment submissions. Therefore, in context we support the "8%" standard as superior to the "4%" standard.

Early Action

Throughout the rule development process, there has been a consensus among stakeholders that "early action" should be encouraged. Nonetheless, there has been some discussion of granting early action credits at a rate of less than one credit for one ton of reductions. This decision would clearly be discouraging, rather than encouraging, as it would create an incentive to delay actions until program onset, in order to obtain the full credit. MSCG strongly recommends that the final rule clearly adopt a "one ton, one credit" standard for granting early action credits.

Offset Protocols and Linkages

As a matter of design principle, we have argued that a "4%" limit on the use of offset credits is too restrictive. However, from a practical perspective, many industry participants believe that there are unlikely to be enough offset credits available in the first few years of the program to even supply the full 4%. Given this fact, and the recent increase in emphasis on cost containment aspects of the GHG program, MSCG believes that the ARB should accelerate its development of offsets protocols and linkages. Such finalization is needed to remove uncertainty and unleash investment. Key questions that should be answered in the final rule include:

- In addition to the four offset protocols currently being evaluated, what additional protocols will be considered, and on what timetable?
- Will CARB develop its own registry?
- What offset programs will California link to, and within linked programs, what parameters will be applied to determine which offsets will be accepted (Types? Locations? Vintages?) ?

Liability of Invalidated Offsets

Our understanding of current Staff thinking on who bears the liability for invalidated offsets accredited by the ARB is that it will reside with the entity that holds the offset at the time of the invalidation. MSCG does not believe this is the optimum approach to this issue. First, such an approach is inconsistent with the principle of assigning the responsibility to the entity which is at fault. Second, it would abdicate the responsibility of the accrediting organization to perform due diligence before granting accreditation. Third, such an approach would be hugely disruptive and inefficient commercially. The entity unlucky enough to be holding a given invalidated credit at the time the "music stopped" either would not have any contractual relationship, and hence recourse, to the originating entity, or would potentially have to trace back the liabilities through the entire purchase and sale chain for the entire history of the credit, with each party bearing liability to its customer and trying to collect from its supplier.

We believe that there are less disruptive options available, including financial insurance policies, creation of reserves for replacement credits, and so on. Approaches of this sort have been adopted by other jurisdictions that have addressed this issue, and such solutions have enjoyed broad support by stakeholders. While we have no formal polling data, our sense of the stakeholders involved in this issue is that the majority would prefer solutions other than assigning financial liability to the holder of the offset, rather than the

creator or the certifier. We urge the ARB not to adopt a protocol that most stakeholders view as suboptimum.

Allocations of Allowances

MSCG has consistently supported 100% auction of allowances in previous comments, and continues to do so. Our understanding of the ARB's current thinking on auctions versus allocations is that concern over impact on trade-exposed businesses necessitates a significant degree of free allocations. If so, MSCG strongly recommends that allocations to entities with compliance obligations not attempt to meet their anticipated full requirement. Instead, every entity should be allocated an amount that ensures it starts with an expected net short position, and preserves some allowances for auction.

One of the major "lessons learned" from the European Union launch of its emissions trading system is that many emitters were over-allocated, and had no motivation to transact in the market. This caused the allowance market to be very illiquid in its early stages, as allocation recipients were overly cautious about offering surplus allowances for sale. California should not repeat that mistake. Carefully targeted allocations that supply trade-exposed emitters with allowances that cover a significant portion, but not all, of their requirements will provide the economic buffer desired while still facilitating a quick start to a liquid and competitive market. This is important for realizing the innate benefits of a cap-and-trade system.

Entities without compliance obligations are not "trade exposed", and so should not be granted free allocations. However, if ARB nonetheless decides to provide such entities an allocation, there should be an absolute obligation to offer these allowances into the market within a fairly short time period after receipt. No banking or unilateral decisions to "retire"[1] should be permitted for these entities.

Borrowing

Although previously rejected, it is our understanding that the use of allowances from future vintages for current compliance periods (borrowing) is once again under consideration. MSCG reiterates its view that this practice should not be adopted. First, it is a "robbing Peter to pay Paul" approach. Premature removal of allowances from future periods for current compliance changes the shape of the emissions decline curve, changing it from a "steady decline" to a "falling off a cliff" profile. It essentially removes this decision from policy makers, and empowers emitters to unilaterally change it.

At some future point, the amount of allowances available will drop at a much steeper rate than envisioned when the program was devised. Such an increasing rate of decrease is likely to cause a steep rise in the price of allowances, and perhaps even cause economic disruption because of the accelerated pace of change. Furthermore, allowing

[1] MSCG does not oppose entities buying allowances on the open market and retiring them. However, retirement by an organization receiving a free allocation amounts to a de facto decision to unilaterally accelerate the emissions reduction schedule chosen by the appropriate regulatory and legislative authorities, at no cost to itself.

individual emitters to increase future costs for other emitters by failing to take action to reduce emissions today should not be permitted.

This flaw is aggravated if “borrowing” is penalized by some sort of “discounting” or “interest” factor that requires more than a ton of future vintage allowances to meet compliance obligations for a ton of emissions today. Other approaches, which require physical payback of allowances advanced from future periods, create issues around certainty of repayment, in, for example, instances of bankruptcy. For all of these reasons, we strongly recommend against adoption of any sort of “borrowing” scheme.

Minimum Auction Prices

As discussed in our comments on price collars, a minimum price in the auction serves only to increase costs to consumers. This would not be consistent with the recent increased emphasis on cost containment. The same arguments advanced against “floors” in price collars apply to auction minimums. It is our understanding that recently, an additional argument for setting a minimum auction price has been advanced: that it prevents “collusion”. However, there does not appear to be any reason why the incentive to collude is greater when the de facto minimum is $.01 than when it is at some higher, artificial level.

The best prevention available in market design against auction collusion is vigorous participation in both the primary and secondary markets. Large numbers of buyers and sellers make effective collusion a practical impossibility. Furthermore, civil, criminal and regulatory remedies are available against colluders, and auctions will presumably be closely scrutinized by an effective market monitoring scheme. With all of these preventative measures in place, the incremental value of an auction minimum for collusion prevention will be minimal or nonexistent. For all these reasons, MSCG strongly recommends against any minimum auction price.