

If you have questions or would like additional information on the material covered in this Alert, please contact one of the authors:

Jennifer A. Smokelin
Counsel, Pittsburgh
+1 412 288 3016
jsmokelin@reedsmith.com

Lawrence A. Demase
Partner, Pittsburgh
+1 412 288 4050
ldemase@reedsmith.com

Todd O. Maiden
Partner, San Francisco
+1 415 659 5918
tmaiden@reedsmith.com

Nicholas Rock
Partner, London
+44 (0)20 3116 3685
nrock@reedsmith.com

Peter Zaman
Partner, London
+44 (0)20 3116 3686
pzaman@reedsmith.com

...or the Reed Smith lawyer with whom you regularly work.

AB 32 and GHG Market and Auction Basics

On August 30, 2012, the California Air Resources Board (CARB) and about 150 market participants held a test auction for the purchase and sale of California carbon allowances (CCAs). The California state legislature passed Assembly Bill 32 (AB 32) in September 2006 requiring the state to reduce greenhouse gases emissions to 1990 levels by 2020, a 17 percent reduction. California's auction is part of a cap and trade program designed by CARB. California's cap and trade program is just one piece in California's efforts to meet the 17 percent reduction required under AB 32 by 2020.

In sum, a carbon allowance allocation (see our accompanying Client Alert "Client Alert: AB 32 and Cap and Trade Design Basics") and the emissions offset program (see our accompanying Client Alert "Client Alert: AB 32 and Offset Basics") under AB 32 create the largest North American carbon market – but elements of the California program, such as specific auction rules, unlimited banking, limited use of offsets, and certain cost containment measures, will undoubtedly shape trading strategies different from those in existing carbon markets. To understand the California carbon market, it is therefore important to understand the auction and the auction rules.

– AUCTION AT A GLANCE –

- *The first California cap and trade compliance period begins **January 1, 2013***
- *Distribution of credits for compliance is, in part, via auction*
- *CARB plans to conduct the first quarterly auction **November 14, 2012***
- *Allowances purchased at advanced auctions are not valid for compliance purposes until the year of the allowance (e.g., 2015 allowance) or future dates*

- *The advanced auctions are designed to prepare entities for future compliance obligations and to give price signals for the 2015–2020 periods*
- *In order to participate in a live auction, each bidding entity must register, meet financial regulatory requirements, and post bid guarantees*

THE MARKET California's cap and trade program will mark the emergence of the first large-scale carbon price in the United States, raising the question of what California's influence will be, if any, on other national and international carbon prices. Prices in the EU for carbon under the EU Emissions Trading System (EU-ETS) have been volatile, the benchmark carbon price fell to a low of €5.99 (US \$9.50)/ton in April 2012, and recovered in September 2012 to more than €8 (US\$12.80).¹ However, EU prices are easily depressed because of investors' perception of oversupply. Prices under other U.S. regional programs have remained low in the \$2/ton range² because of lack of cap stringency. Because there is no linkage between the California program and either the EU ETS or to the Regional Greenhouse Gas Initiative (RGGI), California carbon prices will not affect these other markets.

- **VALUE OF CALIFORNIA MARKET:** CARB anticipates that the credit prices in the early years of the cap and trade program (Phase I) will range from \$15 to \$20/ton.³ Offset prices under the California system may be slightly lower, but some experts estimate offsets will be in short supply (thus driving up price).⁴ For more discussion of the "offsets" under the California cap and trade program, see our accompanying Client Alert "**Client Alert: AB 32 and Offsets.**" Under the California system, Phase I (2013-2014) will include a narrower scope of emissions (electricity generators and large industrial facilities), but that is broadened in Phase II (2015-2020) (Phase I emissions plus transportation fuels), and could result in a \$3.95 billion market, assuming a \$10 per metric ton price in 2015.⁵ Experts predict this could grow to a \$40 billion-a-year market by 2020.⁶
- **SECURITY OF CALIFORNIA MARKET:** CARB is very concerned about market oversight and security. CARB requires: (i) program and auction registration; (ii) enforced holding limits; and (iii) that all compliance instruments, whether allowances or offsets, exist solely within a CARB-centralized allowance tracking system. CARB regulations expressly prohibit any trading involving manipulative devices or any attempt to corner the market.⁷ Further, CARB has selected Monitoring Analytics, LLC as market monitor to create a system to monitor the transfer and holding of allowances both at auction and on the secondary market.⁸ However, the details of this system are not expected to be released until 60 days before the first auction.

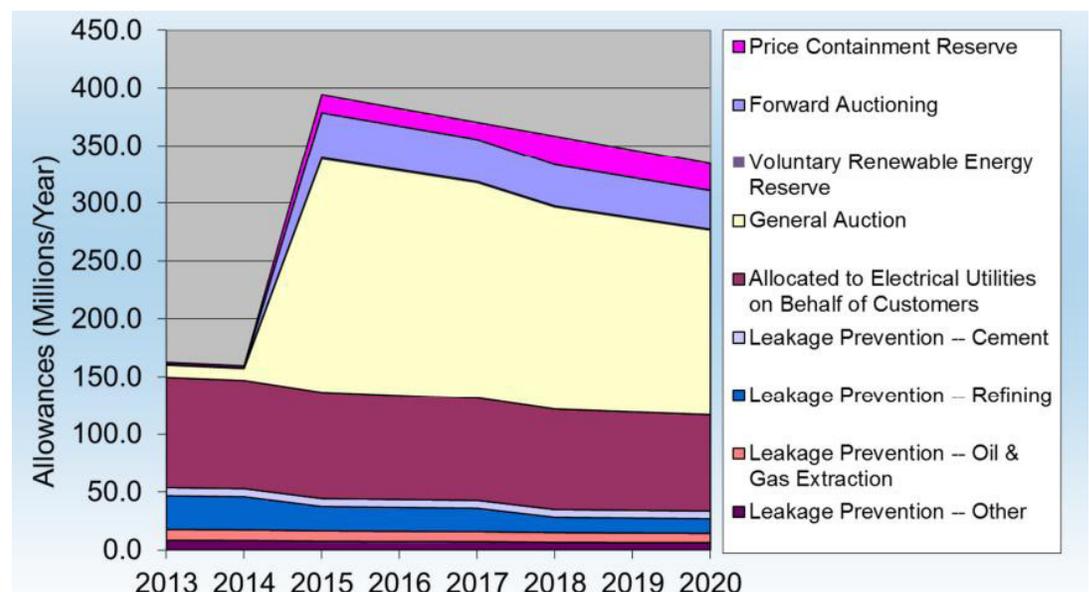
California market participants have already been engaged in trading of forward contracts for CCAs and some offsets, with the price for 2013 CCAs on the

Intercontinental Exchange (ICE) trading at more than \$15 in 2Q2012, well above the auction reserve price (of \$10).⁹ Trading volume is picking up; more than 1,000 contracts for CCAs traded on ICE in August 2012, up from 246 in May, 2012¹⁰. Prior to the first auction, market price indicators include the floor price set by CARB for the auction (\$10 escalated annually by 5 percent over inflation), and the reserve price set by CARB (\$40 escalated annually by regulation and 5 percent over inflation), the price for 2013 CCAs on the ICE. Once cap and trade is effective, CCA peak prices are likely to occur at true-up and at annual surrender.¹¹ On related pricing issues, it is important to note that currently CCA futures are trading with a fair amount of discounting because of the fact that many believe the California cap and trade program will not start as scheduled in January, 2013 – it has been delayed twice already and CARB is still facing court challenges to the regulations, as well as pressure from some state politicians to amend parts of the program.¹²

In addition to forward trades, parties will be able to purchase CCAs through bilateral contracts and secondary markets. Purchase from secondary markets or through futures or forward contracts are not limited by CARB,¹³ but CARB will enforce certain “holding” limits in registry accounts.¹⁴

THE AUCTION

(1) PRE-AUCTION INFORMATION Since auction will shape the market in many ways, market participants need to understand the auction. As demonstrated in the chart below, over the course of the program, CARB will initially sell a small amount of allowances in the first auction (about 10 percent), ramping up to a larger amount over time (see yellow “General Auction” in chart below). All allowances indicated as “leakage prevention” and “on behalf of customers” in chart below are given to compliance entities for free.



Source: California EPA

– AUCTION PARTICIPANT INFORMATION AT A GLANCE –

- *Basic steps: apply for auction, post bid guarantee, bid, receive auction results, remit payment*
- *Auction participants must have CITSS account*
- *Sealed, electronic bids; three-hour bid window*
- *In order to participate in a live auction, each bidding entity must separately register 30 days prior, meet financial regulatory requirements, and post bid guarantees*
- *Sum total of auction bids must not exceed bid guarantees, which must be posted 12 days before auction*
- *CARB will post registration for each auction 60 days prior to the auction. Deadline to register 30 days prior to auction.*
- *Auction bids must include whole dollar amount, number of lots (1,000 allowances), and vintage*
- *Bids are rejected if they exceed purchase limit and holding limit, or do not exceed floor price per allowance*
- *Utilities can consign allowances to be sold at auction*

At auction, California will use Compliance Instrument Tracking System Service (“CITSS”) as a registry and transaction log for carbon instruments. To participate in California’s cap and trade auction, an individual or entity must have a CITSS account. For more discussion of the CITSS account under the California cap and trade program, see our accompanying Client Alert “Client Alert: AB 32 and Cap and Trade Design Basics.”

To demonstrate market and auction capabilities, CARB held a “test” auction August 30, 2012. No money changed hands, but this allowed future market participants to become familiar with the trading system. Further, CARB did not release the auction results (i.e., settlement price, defined below), so as to avoid sending false price signals to the active market in forward contracts for CCAs.¹⁵ For the same reason, CARB also did not announce the number of allowances that cleared in trading among the more than 150 participants at the test auction.¹⁶

(2) AUCTION RULES Since auction rules will shape market-trading strategy, it is important for market participants to understand the auction rules. A bidder must register for an auction 30 days prior to auction.¹⁷ At auction, users sign in with a secure username and password, and during the pre-determined “auction open” hours (bidding window), bidders place an order in whole dollar amounts for as many emissions allowances as they want to buy in terms of the number of “lots”

desired (each representing 1,000 allowances) and a “vintage” year, corresponding to the compliance phase for which the allowances would be used.¹⁸ Not all bids in any given auction will necessarily be honored because only a certain number of allowances will actually be sold at each auction. Bids from other users are kept private and hidden from view – making this a “sealed-bid” auction platform like that used in RGGI. During the bidding window, users are free to modify or rescind bids. Once the bidding window closed, all bids are final.¹⁹

While there is banking for CCAs from one compliance period to another,²⁰ there are also “vintages” on each CCA, and a CCA cannot be used for compliance purposes before its “vintage”.²¹

The first “live” auction is scheduled for November 14, 2012, when CARB plans to auction, in total, both 20 million current (vintage 2013) allowances and 40 million (vintage 2015) allowances, each available in lots of 1,000 allowances. In addition, entities holding allowance can consign their allowances for sale at auction.²² Notice of this auction is posted on CARB’s website (www.arb.ca.gov).

In addition to regular auctions, CARB will hold quarterly advanced auctions for a portion of the 2015-2020 allowances. Allowances purchased at advanced auctions are not valid for compliance purposes until the year of the allowance (e.g., 2015 allowance). The advanced auctions are designed to prepare entities for future compliance obligations and to give price signals for the 2015–2020 period. For 2013, the auction will be held February 19, May 16, August 16, and November 19.²³ Utilities can consign allowances for sale but the deadline to consign allowances is 10 days before the 2012 auction and 75 days prior to the auction in 2013.²⁴

(3) POST AUCTION AND SETTLEMENT BASICS Following any given auction, CARB evaluates the bids and determines which are accepted and which are rejected, based on the CARB regulations.²⁵ After a live auction, CARB will certify whether the auction was operated pursuant to regulation, and, after certification, CARB will publish at www.arb.ca.gov the names of bidder, the auction settlement price, and aggregated information regarding allowances purchased with the names of entities withheld.²⁶ CARB will also direct Deutsche Bank to (i) collect payment or declare forfeit from bidders, as appropriate, and (ii) deliver consigned proceeds.²⁷

— POST AUCTION AT A GLANCE —

- *Bids are filled from highest to lowest until either all allowances are sold or reserve price is reached*
- *After the auction, the following information will be publicly released:*
 - *Names of qualified bidders*

- *Settlement price*
- *Auction summary*
- *Auction settlement price: defined in this market as the higher of the next highest bid above the floor price (\$10 initially, but that reserve price increases by 5 percent (above inflation) in ensuing compliance periods), or the last highest bid that clears*
- *All allowances are sold settlement price*
- *CARB will approve the trades within 48 hours after bids are verified and payment is posted by participant*

Post-auction, settlement price will inform forward market trades since all allowances at auction are sold at settlement price. Therefore, settlement price is an important issue. Settlement price is defined in this market as the higher of the next highest bid above the floor price (\$10 initially, but that increases by 5 percent (above inflation) in ensuing compliance periods) or the last highest bid that clears.²⁸

Finally, after auction, CARB will (1) transfer the serial numbers of the allowances purchased into each winning bidders' holding account after determining such bidder has deposited appropriate payment in the Air Pollution Control Fund, and (2) inform each approved GHG emission trading system (and the associated tracking system) of the serial number of allowances purchased at auction.²⁹

In sum, the carbon market and auction in California is moving ahead and promises to be a dynamic new frontier for US domestic carbon emission control. As with any "new frontier," there are risks and opportunities. Every business touched by this new frontier has a basic goal: capitalize on the opportunities and avoid the risks. Understanding the basic market and auction framework is a good start for identifying the opportunities and avoiding the risks. If you have further questions, contact any of the authors listed above or the Reed Smith attorney with whom you currently work.

1. See Point Carbon market data <http://www.pointcarbon.com/news/euets>

2. In RGGI's March 2012 auction, CO2 allowances settlement price was \$1.93, the minimum price for the auction. See <http://www.ggi.org/news>

3. See "Allocating Emission Allowances Under a California Cap and Trade Program," a report by CARB's Economic and Advisory Committee (2010).

4. "California Carbon Market to be Short of Offsets: Report," Reuters Point Carbon, September 14, 2012.

5. \$10 per metric is the auction “floor” price under AB 32 for 2013, 95856 (increases every year CPI+5%). For more discussion of the “basic design elements” under the California cap and trade program, see our accompanying Client Alert “**Client Alert: AB 32 and Cap and Trade Design Basics.**”

6. <http://www.reuters.com/article/2012/09/07/us-california-carbon-idUSBRE88600S20120907> In comparison, the EU carbon market is valued at \$176 billion and has a turnover rate of three times the volume of allocated allowances. See State and Trends in Carbon Market, World Bank, May 2012

7. 17 CCR § 95921(e)

8. <http://ww.arb.c.gov/cc/capandtrade/implementation/resource-archive.htm>

9. “California Carbon Soars 14 Pct As New Buyer Enters,” (Reuters Point Carbon)

10. <http://www.reuters.com/article/> (April 19, 2012).

“Carbon Trading Heating Up,” Wall Street Journal (online), September 14, 2012.

11. For an in depth discussion of these topics, see our accompanying Client Alert “Client Alert: AB 32 and Cap and Trade Design Basics”

12. For a discussion of the regulatory, legislative and court challenges to the program as of September 2012, please see Reed Smith CLE teleseminar Sept. 11, 2012, posted www.environmentallawresource.com

13. However, some capped entities are regulated by other entities; for example, investor-owned utilities are subject to limitations on CCA procurement imposed by the California Public Utility Commission.

14. 17 CCR §§ 95914 and 95920(b)

15. <http://www.arb.ca.gov/newsrel/2012/poolreport.htm> (Pool Report from practice auction)

16. Id.

17. 17 CCR § 95912

18. Id.

19. 17 CCR § 95911

20. Id.

21. Id.

22. 17 CCR § 95910(d)(4)

23. 17 CCR § 95910(a)

24. 17 CCR § 95910(d)(4)

25. 17 CCR § 95911

26. 17 CCR § 95912(f)(2)

27. 17 CCR § 95912(k)

28. 17 CCR § 95802(a)(20)

29. 95912(k)