

AB 32 Cap-and-Trade Auction Frequently Asked Questions March 2013

Tim O'Connor, Director, toconnor@edf.org, (916) 549-8423
Emily Reyna, Senior Project Manager, ereyna@edf.org, (415) 293-6068

On November 14, 2012 and February 19, 2013, California successfully held the first two auctions of its landmark greenhouse gas cap-and-trade program. The state will continue conducting tightly controlled auctions for greenhouse gas (GHG) allowances every quarter through 2020. Compliance obligations under the program began on January 1, 2013, with the first carbon allowances to be surrendered by regulated entities in 2014. For more information, please contact the authors of this FAQ or visit the California Air Resources Board (CARB) website.ⁱ

Auction basics

Q. Why is California auctioning allowances?

A. Cap and trade is a tool for achieving California's emission reduction targets. At the start of the program, approximately 90% of California carbon allowances (CCAs) are given away for free to companies; the remainder is auctioned. Auctioning CCAs sends a price signal on the value of those emissions and guarantees that all regulated entities, large and small, have access to allowances on an equal footing, reducing the risk that the market becomes dominated by a few players. Furthermore, auctioning CCAs generates proceeds the State can use to achieve further policy goals (such as reducing climate change impacts on disadvantaged communities) that may not be achieved if all allowances are given away for free.

California Auction Fast Facts

Schedule of Auctions: Auctions are held quarterly through 2020, with the first auction on Nov 14, 2012, and are open to qualified bidders. Auctions will be held in Feb, May, Aug and Nov.

Auction format: Single-round, sealed-bid, uniform-price

Minimum sale price: Currently \$10 per allowance, allowances are sold in lots of 1,000

Auction Proceeds: Must further the goals of AB 32. Overall, 25% are required to be used in ways that benefit disadvantaged communities.

Q. Who can participate in the auction and why participate?

A. Compliance (regulated) and non-compliance entities, as well as individuals, can participate in the auction as long as they register 30 days prior to auction, meet the financial regulatory requirements, and post bid guarantees. Approved offset registries, verification bodies, and offset verifiers are not allowed to hold allowances and thus are not eligible to participate.ⁱⁱ

A regulated entity might participate if it anticipates needing CCAs to cover its emissions, and believes that purchasing them through the auction will be less costly than reducing its emissions. A non-regulated entity may decide to participate if it foresees future regulation. For example, a company that falls just below the emissions threshold could trigger regulation under cap and trade if it increases production or loses efficiency. Other non-covered entities, such as brokers, non-profits, or individuals, may wish to participate in order to purchase, sell, or voluntarily retire allowances.

Q. How often will auctions take place?

A. The first two auctions were held on November 14, 2012 and February 19, 2013. Auctions will continue to take place quarterly through 2020. Specifically, they will occur on the 12th business day of the second month of each quarter, every February, May, August and November.ⁱⁱⁱ

Q. What has been sold at the auctions to date?

A. California held two simultaneous auctions at each of the first two auctions. The November 2012 auction sold allowances that can be used for emissions obligations in 2013 and beyond, as well as allowances that can be used starting in 2015. Similarly, the February 2013 auction sold allowances that can be used starting in 2013 and 2016, respectively.

Q. What portion of California allowances are offered for sale at auction?

A. Over the lifetime of the program, the percent of total allowances allocated free starts at about 90% and decreases in the second and third compliance periods (2015-2017 and 2018-2020, respectively). This decrease means more allowances will be available for sale in future auctions. CARB has contracted with experts to analyze whether additional free allowances are needed to prevent emissions leakage, and will update the regulation as needed. 100% of the allowances distributed to Investor Owned Utilities (IOU) are auctioned with proceeds used to benefit ratepayers. Auctioning of Publicly Owned Utility (POU) allowances is determined by individual POU governing bodies.

Auction Rules

Q. What is the auction format?

A. The allowance auctions are conducted using a *single-round, sealed-bid, uniform-price* format. Bids are submitted electronically using a secure internet-based auction platform. This is the same auction format used by the [Regional Greenhouse Gas Initiative \(RGGI\)](#) cap-and-trade program in the Northeastern U.S. Under this format, bidders may not communicate with one another, but may submit multiple confidential bids for a specific quantity of allowances at specific whole U.S. dollar amounts. Each bidder receives the quantity of allowances specified in their winning bids at the uniform settlement price. Allowances are bid and sold in lots of 1,000 units (tons).

Q. How is the final allowance price determined by the auction?

A. With the uniform-price format, the settlement price is the value of the lowest winning bid. The highest bidder is allocated their requested quantity of allowances first, the second highest bidder theirs, and so on, until there are no more allowances. Regardless of original bids, all winning bidders pay the same price (the settlement price), though no bid may be selected below the minimum allowable bid, which in 2013 is \$10.71. In the event that not all allowances offered for sale are purchased, remaining allowances are offered for sale in the next scheduled auction.

Q. What is the California reserve sale and how does it work?

A. If the final settlement price of the auction exceeds a pre-set level identified in the regulation, CARB will hold a follow-on “reserve” auction six weeks after the close of the second auction, and for each auction thereafter. Reserve sales are allowances sold from the Allowance Price Containment Reserve (APCR). The APCR is composed of allowances held back from auction each year – 1% for 2013-2014, 4% for 2015-2017, and 7% for 2018-2020. Allowances from the APCR are divided into three equal-sized tiers – in 2013, one of these tiers will become available at each of the following prices: \$40, \$45 and \$50 (these prices will increase by 5% annually plus the rate of inflation).

Q. Why are future allowances sold? Can entities bank credits?

- A. Allowances for future years are sold to ensure that entities with long planning horizons have the opportunity to secure compliance with the regulation early into the program. In combination with the use of a quarterly market, selling future allowances helps prevent a bidder from “shocking” the market with an unexpected large jump in demand for allowances. In addition to selling future allowances, the program rules also allow entities to buy and hold emission allowances until they are needed for future compliance obligations. Holding limits on the number of allowances an entity can retain will prevent allowance hoarding.

Auction safeguards

Q. What has CARB done to ensure the integrity of the auction?

- A. CARB has taken several steps to ensure proper oversight and security to prevent gaming and illegal market manipulation. The program requires (1) secure program registration; (2) enforced holding and purchase limits; and (3) a centralized allowance tracking system where all compliance instruments, allowances or offset credits, will exist.^{iv}

CARB has also contracted with an independent Market Monitor, Monitoring Analytics, LLC to monitor, detect and report any issues related to the auctions, reserve sales, and secondary markets. [Monitoring Analytics](#) currently operates oversight of the PJM electricity market in the Northeast. CARB and the Market Monitor will review all auction results and financial settlements will not be processed until CARB has certified the auction results. In this role the Market Monitor acts as a watchdog over the program as a whole. Any questionable behavior is subject to further investigation and prosecution by state enforcement officials.

Q. What types of market simulations have been conducted?

- A. CARB has engaged the University of California and other private consultants to perform market simulations. These market simulations are responsible for creating models and running experiments based on the market structure and market rules of California's program. These activities will be used to identify opportunities for program improvement, including identification of market rules that might lead to market disruptions or inefficiencies.^v

After the auctions

Q. What auction results are publicly available?

- A. Auction results are available to the public in a report that includes (1) the auction settlement price, (2) a list of qualified bidders, (3) the number of allowances sold at auction, (4) the ratio of total quantity of allowances bid to total allowances available for sale, and (5) the total percent of allowances purchased by compliance entities. Once CARB has certified the auction, results are posted to both the [ARB website](#) and the [WCI Auction Platform website](#).^{vi}

Q. If a compliance entity does not win any bids, how else can allowances be obtained?

- A. Compliance entities can obtain allowances through future quarterly auctions or reserve sales held by CARB. Alternatively, entities are able to buy allowances from other entities that are selling excess, through secondary markets or through purchase of approved offsets. No more than 8% of an entity's compliance obligation can be met with offsets.

Q. How likely is it that the results of the first two auctions are reflective of future auction results?

A. Since trading activity in the California market is still in its infancy, it is possible that the results of the first two auctions will not be predictive of long-term market dynamics. Differences between the first two auctions and future auctions may include differences in the settlement price, percent of allowances purchased, and number of entities registered.

Q. What will happen to the money that is raised through the auction?

A. All proceeds from the auction of non-utility allowances are deposited in the GHG Reduction Fund. In accordance with legislation, including the state budget, [AB 1532](#) and [SB 535](#), proceeds from this fund will be invested to further the goals of AB 32, funding solutions that allow California to reduce pollution, increase clean energy generation, keep energy prices down, and lessen the impacts of global warming. Twenty-five percent of proceeds are required to be used in ways that benefit disadvantaged communities.

The Department of Finance is currently developing a three-year investment to fulfill the obligations. To that end, the state held three workshops in February 2013 to solicit public input during the development of the first investment plan. The Department of Finance will submit the final plan to the Legislature in May 2013.

Q. What is the best resource for additional information on the auction?

A. The Auction Platform allows the public to view and download auction results, see the auctions calendar and other resources. It is available at <https://www.wci-auction.org>. General information about the program can be found at the Air Resources Board Climate Change Program web site at: <http://www.arb.ca.gov/cc/cc.htm>.

Auction Observations

Q. What have we learned from the first two auctions?

A. The results from the first two auctions demonstrate that California has created a strong, viable carbon market. In both auctions, California sold all 2013 allowances. Moreover, market statistics emphasize the growing confidence in the program. The second auction, for example, saw a 25% increase in the number of qualified auction participants relative to the first auction. Interest in future allowances, likewise, has grown. While the November auction sold 14% of 2015 allowances available for sale, the February auction sold 46% of the available 2016 allowances.^{vii}

Environmental Defense Fund's role - EDF's role in the auction is focused solely on the successful implementation of California's cap-and-trade program. EDF is committed to understanding and communicating information about the auction process to ensure it runs seamlessly and effectively.

ⁱ CARB, 2012, available at www.arb.ca.gov/cc/capandtrade/capandtrade.htm

ⁱⁱ CARB, 2012 Auction Notice Attachment A, available at <http://www.arb.ca.gov/cc/capandtrade/auction/auction.htm>

ⁱⁱⁱ 17 California Code of Regulations §95910

^{iv} CARB, Market and Oversight Factsheet, available at http://www.arb.ca.gov/cc/capandtrade/market_oversight.pdf

^v CARB, 2012, available at <http://www.arb.ca.gov/cc/capandtrade/simulationgroup/simulationgroup.htm>

^{vi} <http://www.arb.ca.gov/cc/capandtrade/auction/auction.htm> and <https://www.wci-auction.org/>

^{vii} CARB, 2012 Auction Notice available at <http://www.arb.ca.gov/cc/capandtrade/auction/auction.htm>