

# 1 The RGGI review: learning from other markets

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POINT CARBON ANALYSIS – RGGI officials proposed adding a cost containment reserve to the program and simplifying current offset usage rules. They have not yet announced new caps or proposed special treatment for the existing bank of allowances, which are the keys to fixing the currently long market. We also discuss how a “backloading” proposal from the EU ETS could work in the RGGI context to tighten the market in the near term while maintaining the cap and minimizing the risk of high prices.

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At the October 18 stakeholder call, the RGGI states proposed several changes to the program design as part of the ongoing program review. The proposals contained some elements familiar to North American carbon market participants –a cost containment reserve for example– but left open the question of the program’s overallocation. In this analyst update we summarize the key proposals RGGI officials made and present our view of the market implications. We also discuss how a proposal from the EU ETS could work in the RGGI context to tighten the market in the near term while maintaining the cap and minimizing the risk of high prices.

## Keeping prices low

### *Cost containment reserve*

Since the start of the program, RGGI emitters have faced the lowest carbon price of any covered entities, and officials are keen to keep prices low by global standards while simultaneously tightening the cap. RGGI officials proposed to do this by creating a cost containment reserve (CCR) of allowances that would be available in addition to the annual allowance budget for set minimum prices. In theory the reserve functions much like California's Price Containment Reserve - additional supply is available under high price conditions. In contrast to the California model, however, RGGI officials propose adding CCR volume *above* the cap. States would generate 10 million short tons (Mt) of allowances to fill the CCR, and this volume would be replenished annually if emitters deplete it. The CCR price would be set to \$5/t in 2014, rising to \$7/t in 2015 – 2017, and \$10/t in 2018. While the ten dollar maximum price is only a quarter of California’s *lowest* reserve price, it would cap allowances significantly above today’s price of around \$2/t.

CCR allowances would be offered by states at the same auction as “normal” allowances, but only sold if (1) all available “normal” allowances are purchased and (2) the auction clearing price is above the year’s minimum CCR price. All participants currently allowed to participate in an auction – including financial institutions – would be allowed to purchase CCR allowances that will be fully fungible for compliance.

### *Offsets*

Offset usage would remain as another means of lowering the cost of compliance, despite emitters’ current lack of interest – no offsets were used for compliance in the first control period. The offset quota will remain at 3.3 percent, but the [current price triggers](#) that allow for expanded offset usage would be eliminated, or possibly reduced to a single trigger set above the CCR price. The potential use of international credits (CERs) would be eliminated, but the

existing US forestry offset protocol would be replaced by California Air Resources Board's (CARB) forestry protocol. In our view allowing CARB forestry credits into the program will have little impact in practice given price levels in the two markets. We see California allowance prices [ranging from \\$12/t in 2013 to \\$58/t in 2020](#), and California offset prices will likely track this price path from their [current levels of \\$10 - \\$13/t](#). Holders of forestry credits will sell them into the California market for a much higher price than RGGI buyers would offer, given the aforementioned CCR prices of \$5 - \$10/t, thus no credit supply from these projects would be available to RGGI buyers.

Simplifying offset usage rules by eliminating multiple price triggers will give more certainty to project developers and could lead to the creation of RGGI offset supply – but only if prices approach the CCR levels. As we discuss next, we see this as an unlikely scenario given RGGI's largest issue – a huge private bank of allowances.

### **The 47 Mt question**

Cost containment mechanisms in RGGI are purely academic without accompanying changes to the current allowance oversupply, but officials were silent on that point at their October meeting. They stated the new cap would not be finalized by the time of the next meeting in November, so we have not updated our supply and demand balance outlook since [our April analysis](#). But officials are taking comment on strategies to reduce the huge private bank emitters accumulated at previous auctions, which RGGI estimates to be 47 Mt.

Buyers have shied away from picking up bargain allowances at this year's auctions, purchasing only 61 percent of the total offered. But as we have [previously argued](#), rational buyers will purchase excess allowances in 2013 after a revised model rule is issued, but before it goes into force. This could lead to an additional 56 Mt in the private bank by the end of 2013, based on our forecast of 109 Mt emissions next year. Combined with the existing bank of first control period allowances this represents over 100 Mt of cheap allowances that could easily flood the market and undercut changes made after the review.

### **Downsizing the supply: how to rob the bank**

The most straightforward solution to the bank problem – banning the use of allowances issued before 2014 when the new cap will presumably be in place – would face strong opposition from emitters and other participants currently holding these allowances. Other possibilities as tested in other environmental markets include setting a usage limit on banked allowances, establishing a “2-for-1” surrender policy, or allowing use of banked allowances by a factor related to their cost of procurement - see [our previous analysis for more details](#). These all impart less of a financial penalty to holders of first control period allowances than an outright ban, but still come at some cost and so would also likely face stakeholder resistance.

Altering the cap level directly to account for the bank is tricky. Suppose officials want to cap emissions at 100 Mt, below projected emissions of 110 Mt. RGGI states could auction 100 Mt to force compliance, but under today's oversupply conditions emitters would simply buy 100 Mt (or fewer) and use 10 Mt (or more) from the bank, thereby complying without reducing emissions. Taken to the extreme, states could auction only 50 Mt and rely on emitters to exhaust their 50 Mt bank and meet the 100 Mt compliance target. But in the next year, the cap would still be set to 50 Mt (presumably) and the bank would be empty – now emitters would face a tremendous compliance burden and prices would skyrocket.

A better solution than direct cap adjustment is inspired by the current “backloading” proposal in the EU ETS. Under this scenario, RGGI states would adjust the cap to a new level in line with today's baseline. If they found that emitters did indeed accumulate a large bank in 2013

and auction clearing prices remained at the floor through 2014, states could delay one (or more) auction until later in the compliance period. This would reduce supply in the near term, boosting prices. If prices rose too high – for example if the CCR were depleted – states could quickly reschedule the auction and introduce new supply. If, however, prices remained low – the more likely case in our forecasts – the auction could be delayed until a future compliance period.

A backloading approach is by no means simple: it requires quick and coordinated action among the nine RGGI states and clear upfront communication with emitters about the circumstances under which auctions would be delayed and rescheduled. But it would allow officials to deal with the problem of the bank – they would effectively delay the auctioning of a volume of allowances equivalent to existing holdings until the bank is exhausted – while holding prices near the CCR level and maintaining the environmental integrity of the cap.

## **Conclusion**

RGGI officials are proposing a cost containment reserve, new offset rules, and other changes that will simplify the market structure and provide some price certainty to emitters. But uncertainty remains around the main supply questions – what will the new cap be and what will happen to banked allowances. RGGI officials aim to address these questions in the next few months, and we believe a change in the current cap will be implemented during the second current control – most likely beginning in 2014. Until these issues are resolved, we expect the RGGI market to remain in its current state with low prices and volumes.