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Regional Trading Schemes in the United States

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Introduction

When the Senate ended debate on the Lieberman-Warner Climate Security Act earlier this summer, some observers assumed that the development of compliance greenhouse gas emissions markets in the US ended as well. However, a number of important initiatives underway among the states continue to develop briskly. In at least one case, trading activity has already begun. There are many outstanding issues surrounding these programmes: on their coverage; on their scope and ability to access credits from other markets; and on their survival under a future federal compliance scheme. This article outlines the major regional carbon compliance programmes under development in the US and assesses their principal implications.

Regional Greenhouse Gas Initiative

Any discussion on developing greenhouse gas compliance programmes in the US must begin with the Regional Greenhouse Gas Initiative (RGGI). It is the programme that will be implemented first, on 1 January 2009, and it supports a market that trades today. For an overview of RGGI basics see Table 1.

The RGGI market today is shaped by two major developments: the recent launch of exchange-traded contracts by the Chicago Climate Futures Exchange (CCFE) and the NYMEX Green Exchange (GX); and the inaugural RGGI quarterly auction on 25 September. Though RGGI allowances traded a handful of times in the brokered market since spring, the exchange-traded contracts have greatly increased liquidity (that is, the breadth and depth of activity) and transparency in this young market. Though still thin by any standard, tens of thousands of tonnes now trade on a typical day. The most common structure is for December delivery in RGGI's first compliance year, 2009, but the 2008 and 2010 contracts also see some activity, as do basic put and call options. Given the illiquidity and uncertainty in the RGGI market today, volatility of these contracts regularly hits 100%. Since RGGI allowances initially traded at around US\$7.50, then peaked at US\$8.50 this summer, the contracts have steadily drifted down and currently trade around US\$4.00.

Given the now widely recognised bearish fundamentals of the RGGI programme – the recent Environment Northeast report is just the latest report showing early over-alloca-

Table 1: RGGI Basics

- ▶ January 2009 start
- ▶ Covers CO₂ from 25MW+ electricity generators
- ▶ Caps at roughly 2005 emissions through 2014; 2.5% yearly decrease through 2018
- ▶ 3-year compliance periods
- ▶ Offset use for 3.3% of compliance obligation
- ▶ \$7 and \$10 price triggers increase allowable use of offsets after settling periods
- ▶ Effectively a 100% auction of allowances

tion of the scheme – many people wonder why we see prices above the initial auction reserve level of US\$1.86 at all. Though it is certainly possible that prices will fall to that level at some point, for several reasons particular to this programme it is generally believed that price support will be found above that level. First, the RGGI states will auction practically 100% of the system allowances. By the standards of existing carbon markets this is a radical approach and in principle should create early price pressure simply by forcing covered entities to buy up front, especially in auctions where any actor with financial standing (that is, anyone who posts 100% margin) can buy as well. Second, the first quarterly auction provided just 12.6 million of the annual 188 million allowances in the system, in part because major states such as New York and New Jersey are not yet ready for this auction. Third, the RGGI administrator has the ability to “pull” unsold allowances off the market. Though it is not clear under what conditions this authority would be invoked, the ability to manufacture a supply shock can only support prices. Finally, there is widespread expectation that RGGI allowances (like other credible early actions in greenhouse gas reduction by states and firms) will have some residual value in an eventual federal carbon compliance programme, no matter how uncertain that value is.

Still, given the fact that RGGI has three-year compliance periods, there is no fundamental reason why buyers should rush into the first auctions. In addition, the RGGI programme incorporates an artificial supply mechanism whereby the allowable offset use increases if prices hold above the \$7 and \$10 price triggers. Most important, the system as currently structured simply allocates more allowances than needed given existing emissions levels in the RGGI region. It is, therefore, not surprising that prices have drifted down

in recent weeks. Everyone focusing on developing carbon markets in the US will be looking at the results of the early RGGI auction, but the auctions cleared at US\$3.07, providing none of the surprises or price spikes that some had predicted. That said, these early activities are an important step in the development of carbon compliance in the US.

Western Climate Initiative

No other developing greenhouse gas compliance programme in the US currently supports trading activity (unless we consider speculative activity in certain offsets). Instead we must analyse other programmes by their structure and potential. Perhaps most important is the Western Climate Initiative (WCI), a project of 11 US states and Canadian provinces that counts an additional seven states and provinces, as well as six Mexican states, as observers (see Table 2).

It is important to keep in mind that our understanding of the WCI programme is based on proposed documentation and process meetings and is subject to revision. However, it is clear that the WCI, if implemented effectively, has the potential to become a major trading programme. The most effective programmes exhibit maximum liquidity and maximum opportunity for trading. On these counts alone, the WCI is bound to support a more robust market than RGGI. It covers all six major greenhouse gases; it is multi-sector, covering not just electricity generation but also industrial and commercial sources that emit 25,000 tonnes or more; and it will bring in transportation and other fuel use in its second compliance period. The WCI regime will be big, covering more than 20% of the US economy and more the 70% of the Canadian economy.

The WCI will take effect on 1 January 2012 and aims to reduce emissions 15% below 2005 levels by 2020. Like RGGI, the programme incorporates three-year compliance periods and allows unlimited banking and no borrowing between compliance periods. WCI envisions a potentially robust use of offsets – up to 49% of the total emission reductions. While the precise scope of allowable offsets state-by-state under the WCI is still unclear, it is apparent that the framers of this programme are contemplating potentially far-reaching policies. For example, they are considering rules that would allow for the trade of considerable volumes among all WCI participant jurisdictions, including Canadian and Mexican states that are now observers to this programme. In addition the regulators drafting the WCI programme are proposing some acceptance of credits generated under the Kyoto Protocol's Clean Development Mechanism (CDM) and Joint Implementation programmes (with some

Table 2: WCI Members & Observers

Members:

Arizona, British Columbia, California, Manitoba, Montana, New Mexico, Ontario, Oregon, Quebec, Utah, Washington

Observers:

Alaska, Baja California, Chihuahua, Coahuila, Colorado, Idaho, Kansas, Nevada, Nuevo Leon, Saskatchewan, Sonora, Tamaulipas, Wyoming

added criteria), as well as “offsets or allowances from other government-approved GHG emission trading systems”.

Midwestern Greenhouse Gas Reduction Accord

Just a step behind in terms of development is the Midwestern Greenhouse Gas Reduction Accord (the Accord), an initiative of the Midwestern Governors Association by Iowa, Illinois, Kansas, Manitoba, Michigan, Minnesota and Wisconsin, and which further counts Indiana, Ohio, Ontario and South Dakota as observers. While still in formation, the Accord does resolve to develop a “market-based and multi-sector cap-and-trade mechanism”. The Governors Energy Steering Committee has provided some details on their deliberations to date: a programme covering electricity generators and large industrial sources (and perhaps transportation fuels); a reduction goal of at least 15% below 2005 levels by 2020; and the acceptance of some offsets for at least 10% - and perhaps 50% - of its targets' compliance obligations.

Finally, an alliance of 16 southern governors recently began to discuss how that last, high-emitting region might collectively address greenhouse gas reductions.

Individual State Initiatives

In addition to these active and developing regional carbon compliance programmes, it is important to point out initiatives by individual states outside these regions. Most states have Action Plans or Advisory Committees to study greenhouse gas compliance. Many have reduction goals; for example, Virginia plans to reduce 30% below 2000 levels by 2025. And some have true targets: Hawaii has committed to reducing to 1990 levels by 2020. Not least due to its size, most important among these is, perhaps, Florida. The state has committed not just to making greenhouse gas emissions reductions (to 2000 levels by 2020), but to setting up a cap-and-trade programme for its electricity generators, which will start after January 2010. Florida is actively considering linking to, or perhaps joining, a regional programme or may establish a stand-alone regime.

Finally of note is California's robust carbon compliance work outside of the WCI. The state is establishing a broad

programme with ambitious goals given its population and economic growth projections (1990 levels by 2020). But it is important to underscore that most of the greenhouse gas reductions that will be achieved in California will come via regulatory measures rather than any trading programme.

Possibilities for Linking

Linking carbon compliance programmes is often promoted as the best way to maximise liquidity and cost-containment, but in most cases the rhetoric is well ahead of reality. In some cases linking may be impossible; for example, the EU prohibits linkage to programmes like RGGI with price controls. In other cases linkage will simply be unrealistic; for example, due to its current supply-demand fundamentals it is unlikely that RGGI will hold its \$10 price trigger in order to allow the purchase of CERs by its covered entities. With secondary CER prices currently trading around \$20/tonne, the odds of CER purchases under RGGI are further reduced. The WCI, on the other hand, faces none of these fundamental problems now and may, indeed, create a market across much of North America on its own. The scope of WCI also alleviates concerns over one of the most important issues facing sub-national compliance programmes: leakage, or the migration of emissions outside of programme boundaries. Moreover, in part because California is a major driver of the WCI, the programme will almost surely make use of the well-regarded offset protocol work done by the California Climate Action Registry (CCAR). Indeed some have argued that those in California who want to see a robust traded market are looking to succeed via the WCI where they failed in their own state programme

Motivation of State and Regional Market Development

The motivation of many states to establish these programmes stems from more than just a sense of environmental stewardship. A number of state leaders have expressed recognition of both the inevitability of carbon compliance at the national level and the political capital that is gained for that process by doing the work on carbon compliance at home. The issue of federal pre-emption is ever-present in state and regional carbon compliance programme deliberations. Indeed, some have argued that the very point of such state work is to force the hand of the federal government and shape the outcome of a national programme. The framers of RGGI in fact constructed their programme to be most easily pre-empted: their 20 December 2005 Memorandum of Understanding states that if “a federal program is adopted, and it is determined to be comparable to this Program, the Signatory States will transition into the federal program.” In addition, the RGGI Model Rule expressly references US Environmental Protection Agency-administered monitoring standards. Other state leaders, though, may strongly re-

sist federal pre-emption. For example, it is hard to imagine California submitting quietly to what they consider to be weaker carbon compliance goals being considered at the national level.

Even without federal legislation in play, the implementation of wide-reaching regional and state programmes remains a key force for the development of greenhouse compliance programmes in the US today. Several of these programmes, or at least aspects of them, are likely to continue under any federal regime. Certainly the lessons learned through their development and early trading will shape debate at the national level. The fact remains that before Congress and the next Administration implement any carbon compliance programme, the majority of the country will be far ahead in terms of understanding and being able to identify opportunities in a carbon-constrained world.

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