

# California presses ahead

Californian regulators have dismissed concerns about the start of the state's carbon cap-and-trade programme next year – but plenty of uncertainties are worrying emitters. Gloria Gonzalez reports from San Francisco

If attendance at the Navigating the American Carbon World conference last month is any measure, plenty of greenhouse gas emitters, financiers and intermediaries are gearing up for next January's start of California's greenhouse gas emissions trading programme. But, after the recent postponement of the first allowance auction, another legal challenge and worries about the offset programme, participants are nervous.

"I believe we're going to start on time," California Air Resources Board (ARB) chairwoman Mary Nichols reassured the 700-odd attendees at the conference in San Francisco. "Don't worry about it."

The start of the enforcement provisions of the programme – which will cap greenhouse gas emissions from about 350 emitters next year, and which will ultimately cover 85% of the state's emissions – has already been delayed once, from this January (although facilities are required to measure and report their emissions). And, last month, ARB decided to delay the first auction of carbon allowances until November and run a test auction in August, sparking more jitters.

> *"AB 32 is going to continue to provide work for lawyers as long as it's in effect"*
> Mary Nichols, ARB

The ARB wants to perform testing, simulation and modelling on the programme to demonstrate that the market can function properly, she said. "We may have made a mistake along the way in some feature that we've put into this and we have to be willing to make changes and corrections as we need to along the way."

Further speculation about a potential delay has been caused by the announcement of a lawsuit by two environmental groups that challenges the use of offsets in the cap-and-trade programme.

The Citizens Climate Lobby and Our Children's Earth Foundation claim there is no additionality – that is, that the emission reductions credited are not in addition to business-as-usual – in the four approved Climate Action Reserve offset protocols: livestock manure digesters, ozone-depleting substances, US forest projects and urban forests.

"These offsets would create a huge loophole in the effort to limit greenhouse gases," they said.

Given that the offset programme will provide a vital safety valve to prevent carbon prices spiking, lawyers have warned that emitters might countersue to protect their interests, potentially slowing the launch of the trading system.

'Severability' is embedded in the cap-and-trade regulation, meaning that if one section is found to be in violation of the law, those provisions can be removed from the rest of the regulation, said Timothy O'Connor, director of the California climate and energy initiative of NGO Environmental Defense Fund. However, that would raise wider questions over its viability.

"I think the programme could indeed move forward technically without offsets in it," O'Connor said. "The question [is] ... if you take them out of the market, do you still have the overall push toward full implementation between now and 2020, when you start to ramp down on the emissions allowances? I think that there's an open question there. I think offsets are an integral part of this programme, something that needs to be in there to make sure the cost containment is still there."

"I think there's less concern about that after the conference than there was before it," said Climate Action Reserve (CAR) president Gary Gero. "It seems pretty clear to most observers, I think, that the state has the legal authority to implement an offsets programme. Frankly, we think the specific challenges in the complaint are flawed. We'll certainly be engaged in countering some of those claims with regard to performance-based standards and protocols. We think it's important to adjudicate this as quickly as possible and get it behind us. "

It would be difficult for the cap-and-trade programme to survive without offsets, he said.

"But I don't expect we're going to get there," Gero added. "There is plenty of precedent for the role of offsets and regulatory agencies including offsets in their programmes."

Legislative aides also made it clear at the conference that their bosses would not tinker with the programme, he said, and that their real role would be deciding what to do with the allowance revenues.

"They feel like AB 32 [the bill underpinning the cap-and-trade programme] conferred on the ARB the ability to craft the details of the programme and they are going to respect that," Gero said. "That's also helped reduce some of the uncertainty around the market because there are those who thought the legislature could step in and say 'no more offsets', cut it down from 8% to 4%, change the allocation formulas, and they're not. The rules are pretty well known and established."

The lawsuit has not been served to ARB, Nichols said. "We don't see that case as being one that's particularly well grounded," she added. "We certainly intend to defend all these cases vigorously.

"I believe that AB 32 is going to continue to provide work for lawyers as long as it's in effect. I think we'll just keep on as we have been, doing our very best to make sure that we stay out of trouble."

Regardless of legal challenges, there are concerns that the supply of offsets may be inadequate to meet demand. The Western Climate Initiative (WCI) – which brings together

California and, initially, the Canadian province of Quebec in a wider emissions market – allows emitters to meet up to 8% of their compliance obligation with offsets, but Thomson Reuters Point Carbon's modelling projects that California and Quebec will produce only 79Mt of offset credits, well short of the 239Mt allowed over the life of the programme (2013–20).

Factoring in additional project types that the ARB is known to be considering only brings that total up to 104Mt.

"The assumption is, of course, that everyone will want to maximise that quota," said Elizabeth Zelljadt, a senior analyst with the Norway-based analysis company, at the Navigating the American Carbon World conference. "If you can get an offset, it's always cheaper than the allowance so why wouldn't you want to use the maximum amount that you're allowed?

"It's not given that every entity will think that way, but if they did ... there aren't enough offsets available of the types that are allowed so far."

With just the currently approved offsets, Point Carbon forecasts that carbon prices will rise to about $27 per tonne in 2013, but the ARB will allow more protocols eventually, Zelljadt said. "The minute you run out of offsets, prices are going to skyrocket," she said.

The price could be as low as $13 per tonne if the 8% quota is filled by all the regulated entities. "That's, of course, an extreme scenario, [and is] unlikely ... even if that many offsets are available," Zelljadt said.

Meanwhile, compliance entities are looking for a signal that the market is moving forward and the ARB has not done a great job to date on that front, particularly with its decision to delay the first auction, said Randy Lack, chief marketing officer for trading firm Element Markets.

Gary Gero, Climate Action Reserve: offset challenges "flawed"

"There hasn't been enough of a consistent message to get people on board really in a big way," he said. "There's a fear that they're going to start spending money in the market and have this washed out."

But the delayed auction does give regulated entities a little more time to think about their compliance strategies, said Graeme Martin, director of environmental products for Shell Energy North America.

Some entities continue to struggle with the decision about when to jump into the market out of concern that they could buy products that may turn out to be worthless, while others are struggling simply with the basics of the programme, Martin said.

"A lot of people at large companies aren't necessarily incented to be proactive," Martin said.

The California carbon market is beginning to hum now that concerns about the January start of compliance obligations have largely been alleviated, with allowance and offset prices beginning to rise, said Gero.

"It's starting to look like the path is clear and I think the market is actually starting to understand that," he told *Global Carbon*. "I think we've seen that in the last couple of weeks with prices really starting to go up. People are starting to pay."

The December 2012 California carbon allowances contract rose $0.50 in the last week of April, ending the week at $15.25, according to Green Exchange data.

"The time to get in, if you're going to get in, is sooner [rather] than later ... because all the market analysts think that the prices are just going to continue to rise," Gero added. **GC**