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CALIFORNIA'S NOVEMBER CARBON AUCTION COULD TRIGGER PRICE DROP

Too many credits offered too soon could flatten prices, research firm Bloomberg New Energy Finance finds in new report

New York, 25 September 2012 – California's first allowance auction may overwhelm the state's carbon market by offering too many credits, too abruptly, and too early in the schedule, according to new research from Bloomberg New Energy Finance, the leading provider of news, data, and analysis on clean energy, water, power, and the carbon markets.

Slated for 14 November 2012, the state's first carbon allowance auction may not attract enough buyers to absorb the available supply at prevailing exchange prices. Without strong participation, the auction could cause prices to fall, potentially as low as the \$10/t Containment Reserve 'floor' for certain allowances. The auction is an opportunity for market participants to procure allowances that can be used for compliance in the state's cap-and-trade program, set to kick off on 1 January 2013.

In an ideal world, the auctioning of carbon allowances should be boring. If designed appropriately and carried out in a large and liquid market, a carbon market auction should clear at levels matching the prevailing exchange price and buyers would smoothly absorb the injection of supply. Under ideal circumstances, there would be little difference between buying credits at the auction and buying credits on the traded market.

Conditions in California are far from ideal, however. First, November's auction is very big. The state will issue 61 million allowances on 14 November, equivalent to 38% of California's entire 2013 carbon cap. For comparison, Europe's carbon market, the European Union Emissions Trading System (EU ETS) never offers more than 0.2% of its annual cap in a single go.

Second, California's first allowance auction will arrive abruptly, when the market is still in its infancy. Entities are still forming their compliance strategies, and trading activity has yet to take off. For example, open interest for carbon futures contracts (2Mt, as listed on the InterContinental Exchange) pales in comparison to the 61Mt to be injected into the market on November 2012. By comparison, the volume of open interest for carbon market futures in Europe is currently more than 1.09Gt.

Finally, and perhaps most importantly, November 2012 is early, especially since a portion of the allowances that will be auctioned are not valid for use until 2015. The November auction actually consists of two separate auctions: a 'Current Auction' will feature 22m credits for use in 2013, while an 'Advance Auction' will offer 39m allowances that cannot be retired until 2015. The Advance Auction is particularly at risk of yielding low clearing prices.

Bloomberg New Energy Finance estimates that demand for California carbon allowances will total 56Mt on 14 November 2012 – enough to keep Current Auction prices near the prevailing exchange price (currently \$15/t), but potentially leaving the Advance Auction undersubscribed.

"Very few entities have shown interest in November's Advance Auction", says William Nelson, analyst for North American environmental markets at Bloomberg New Energy Finance. "Most companies are willing to stockpile credits to cover emissions one to two years into the future, whereas there is a four-year span between the November 2012 auction and the date that 2015 allowances are actually due."

If allowances go unsold in November's Advance Auction, clearing prices for the long-dated credits will hit \$10/t, and leftover supply will be re-issued in 2015. This would ultimately cut into California Air Resources Board (CARB) revenues. The state budget is counting on raising at least \$660m through the three allowance auctions held in the 2012-13 fiscal year, but proceeds could miss that mark if buyers do not materialize on 14 November.

Meanwhile, the focus for most market participants is on November's Current Auction, where they hope to procure credits to cover near-term emissions, which begin to count against California's cap on 1 January 2013.

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