Holding Limits in California's Greenhouse Gas Emissions Cap-and-Trade Market

Emissions Market Assessment Committee Meeting

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Reducing the Potential Cost of Holding Limits

- Benefit--Holding limits can prevent market participants from taking unilateral actions to move price of allowances and profit from this price change
  – Buy allowances and withhold them from the market to drive price up
  – Sell some allowances at high enough price to offset cost of acquiring allowances
- Cost--Holding limits can prevent market participants from taking actions to hedge their compliance risk
  – Market participant can be prohibited from buying and holding enough allowances to construct least cost hedge against compliance risk
  – Market participant can end up with excess allowances in compliance account that cannot be sold to other market participants
    - Lost economic benefits to owner of allowances and entity in need of allowances

Net Position versus Gross Position

- Large holding of permits determines ability to market participant to take actions to raise or lower price of allowance
- Net position—Holdings minus compliance obligation—determines incentive of supplier to raise or lower allowance price
  – Both ability and incentive to raise or lower price necessary for market participant find such actions profit-maximizing
- This logic suggests basing holding limits on a supplier's net position rather than on gross position in allowances
  – Current approach sets holding limits as fixed number for all market participants
  – Only compliance account sets limits based on a market participant's compliance obligation
- One-way nature of compliance account could result in stranded allowances in market participant's compliance account
  – Large entity puts allowances in compliance account, but subsequently figures out lower cost way to meet compliance obligation
    - Entity is unable to sell allowance in compliance account that it no longer needs

Net Position versus Gross Position

- To minimize likelihood of stranded allowances, consider two changes to current position limit paradigm
  - Allow sales from compliance account to compliance accounts
  - Base position limits on net position of market participant
- Sales from compliance account to compliance account can be restricted to be within same industry group
- Position limits of non-compliance entities need not be impacted by this change because these entities do not have compliance obligations
- Net position limits would not disadvantage entities with large compliance obligations

Conclusion

- As a general concept, focus on limiting net positions of market participants rather than gross positions
- Allow allowance trading between compliance accounts under certain conditions