Three reforms to protect California's cap-and-trade policy

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California's landmark cap-and-trade system for regulating greenhouse gases could be vulnerable to price spikes and market manipulation, according to a new study released by scholars affiliated with the Energy Institute at Haas. But the state's air-quality regulators can prevent that outcome with three straightforward reforms, the study says.

Specifically, the California Air Resources Board should consider (1) strengthening the new market's price collar—the so-called allowance price containment reserve—(2) allowing permits to be converted from one compliance period to another and (3) providing more public information on emissions and emissions-allowance holdings.

"With a couple of straightforward adjustments, California's course for addressing climate change with a market mechanism would be a model for other states and countries," says Prof. Severin Borenstein, the study's principal investigator and research associate, Energy Institute at Haas, UC Berkeley's Haas School of Business.

In addition to Prof. Borenstein, the study's authors are Prof. James Bushnell at UC Davis, Prof. Frank A. Wolak at Stanford University and Matthew Zaragoza-Watkins, a doctoral candidate at UC Berkeley. Profs. Borenstein, Bushnell and Wolak are members of the Market Simulation Group that advised the Air Resources Board.

There is a small, but significant, risk that manipulation could occur if large emitting entities were to buy and hoard excess permits in hopes of inflating the price and then selling, the new report says.

To minimize risks price spikes and manipulation, the Air Resources Board must ensure that it has a large enough reserve of permits for release whenever the price hits the ceiling, the report says. It should also allow emitters to pay a fee to be able to transfer permits intended for use in later compliance periods to earlier ones.

These measures would add up to "an unambiguous policy that credibly limits the maximum allowance price," the report says. Such a policy "is important to market stability and a strong deterrent to attempts at market manipulation."

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