How vulnerable will California's cap-and-trade program for greenhouse gas emissions be to market manipulation, noncompliance, and fraud? Will the program's public auctions of allowances serve a critical regulatory purpose, or are they just a big money grab? With about four months to go before the highly anticipated first auction, these questions are important and getting increasing play.

Last August, some colleagues and I examined California's proposed cap-and-trade program and looked at its potential for gaming and market manipulation. In reviewing California's regulatory design, we paid special attention to lessons learned from other cap-and-trade and market-based efforts, including the SO2 trading program implemented under the Clean Air Act; the RECLAIM program used to trade NOx and SO2 allowances in Southern California; and the trading of carbon emissions in the European Union (EU ETS). On the whole, <u>our</u> <u>report</u> found that California's program is well-designed and unlikely to lead to market manipulation.

We have now reviewed the program as adopted and find that our conclusions still apply. In our view, the California Air Resources Board (CARB) has done a good job incorporating lessons learned and has designed a robust program aimed at avoiding problems sometimes seen in other programs. Some of our conclusions:

- Auctions promote liquidity and fair pricing, so it is good that IOUs are required to consign their allowances into an auction, and POUs should be encouraged to do the same
- CARB's penalties should be adequate to deter noncompliance
- Auction purchase limits and entity holding limits will decrease the potential for cornering the market
- CARB's tight security over accounts and allowance tracking will help protect against fraud and gaming

<u>This two-page recap</u> highlights our report's top conclusions in light of developments in the trading program. You can <u>find our original report here</u>.

Is California's program bulletproof? No one could make that claim. But it's a very well designed regulatory effort.