

Comments of Morgan Stanley Capital Group Inc.
Utilization of Offsets
California Cap-and-Trade Market
April 30, 2009

Morgan Stanley Capital Group Inc. (MSCG) has reviewed the materials used in the March 23 public meeting to describe approaches and options for the use of Offsets in a California Cap-and-Trade market for greenhouse gas emissions allowances. We appreciate the opportunity to comment on certain key aspects of proposed system. If any party desires to have follow-up questions or discussions, please feel free to contact Steve Huhman, Vice President, at (914) 225-1592, or via e-mail at steven.huhman@morganstanley.com.

MSCG is not supportive of the decision to limit offsets to 49% of proposed reductions. We do not believe that the use of offsets that meet stringent quality criteria should be restricted. Having made that initial point, the remainder of our comments will be focused on how best to administer the offset system within the context of the proposed decision to limit the use of offsets to 49% of reductions.

Individual versus System Limits

The best practical approach is to limit the percentage of each individual entity's compliance obligation that can be met using offsets. However, unused portions of this percentage should be able to be carried over from one compliance period to the next. For example, if the calculated offset percentage is 20%, and Company A has a compliance obligation of 100 that it meets in Period 1 by using 85 allowances and 15 offsets, it should have an offset carryover of 5% to Period 2. Therefore, in Period 2, if it has the same compliance obligation of 100, it could choose to meet this period's obligation by using 75 allowances and 25 offsets. There should be no expiration of carryover rights.

Similarly, the ability to use offsets should be tradable. Revisiting the example above, Company A should be able to sell its unused 5% from Period 1 to another entity with a compliance obligation, or an intermediary. Of course, any amount sold could not be carried over. The instrument traded could not be a percentage, but would have to be a volumetric amount calculated by applying the standard percentage (20% in the example) to the selling company's total compliance obligation. In this variation, Company B could buy the unused 5% from Company A, converted into 5 Offset Compliance Rights. If Company B then had a compliance obligation of 200 in Period 1, it could use its own 20% offset percentage (40 offsets) plus the 5 offsets it bought Compliance Rights for from Company A, and would then be required to use 155 allowances. Note that if it bought the percentage instead of the converted volumetric amount, it would be able to use offsets to meet 25% of its obligation (50) and would then only need 150 allowances to complete its compliance obligation. Purchased rights should also not expire.

The approach outlined above will address two countervailing flaws that exist in using either an aggregate system or individual restriction. The flaw in using individual entity limits is that inevitably, not all entities will use exactly their full allotted amount of offsets. So, the aggregate 49% of reductions amount will not be fully utilized, even when offset supply and price would make this the most efficient outcome. Conversely, system-wide limitations create a high degree of uncertainty among entities with compliance obligations. A system-wide limit without restrictions on individual entities must almost certainly become a first-come, first served system. As the system limit is approached, the offset market is likely to grind to a halt, as parties will be reluctant to buy a credit they are not sure they can use for compliance purposes. Once again, the outcome will be that less than the full 49% of reductions amount permitted will be utilized.

Meshing with WCI

Precise recommendations for this issue are hard to make, as neither entity has finalized its own approach. Ideally, the two groups would have identical rules and harmonization would not be a problem. When this does not occur, the next easiest thing to do would be for California to adjust its program to match. However, it can be visualized that California would be unwilling or statutorily unable to make such adjustments, depending on what would be required.

It may be that the simplest way to make the programs mesh is to design the tradable rights program described above so that California entities can trade Offset Compliance Rights with any jurisdiction that California certifies as having an equivalent program. Presumably this will end up including WCI partners. It should be workable with any jurisdiction that does not allow unlimited use of offsets for compliance purposes.

It would not be necessary for the other jurisdiction to have an identical limit in order for the integrity of the California program to be maintained, only that it HAS a limit. In this way, any increased use of offsets in California via purchased Offset Compliance Rights would be countervailed by an equal decrease in use of offsets in the other jurisdiction. Of course, the other jurisdiction would have to have a similar provision for tradable Offset Compliance Rights. The best result would be if the WCI program is harmonious enough, then the tradable Offset Compliance Rights program can be a single, unitary program, centrally administered.