Market Notes

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California LCFS Credit Market

After an impressive bull run that saw prices increase from $29 in Q1 2013 to a high of $85 in November of 2013, the remainder of the fourth quarter saw a decrease in interest in LCFS credits. The $85 peak rode the wave of a large oil major purchase, after which the market high was set, and LCFS was left over-offered by motived sellers. The selling pressure continued and buyers stepped aside waiting for the next leg down.

LCFS			
	Bid	Ask	Last Trade
Prompt Delivery	$18	$21	$21

Activity slowed into the holiday season, however it picked up again the first week of January. The LCFS market momentarily found some stability at the $40 - $50 range. Tens of thousands of contracts changed hands at $50 as a number of size buyers came to hedge their 2013 compliance deficits. After the compliance buyers cleared out, the imbalance between deficits and surplus credits continued to push the market down. CARB's public statements concerning cost containment at its March 11th workshop did nothing to support price levels. Sellers offering into a vacuum pushed the market to its current low of $18 by early April.

The LCFS regulation was intentionally structured to create a surplus of credits in the early years to assist participants in reaching a 10% reduction in transportation fuel carbon intensity (CI) by 2020 (compared to 2010). However, the overabundance of credits has depressed both credit prices as well as incentives to invest in low CI fuel development. In the first three years of the program, obligated parties hold ~4 million metric tons of deficits vs. 6.6 million metric tons of credits. Much of the drop from the $85 high can be explained by this over supply.

Regulatory

The OPIS LCFS Workshop (December 12 – 13, 2013 in San Francisco, CA) attracted many market participants eager to educate themselves on their obligation and market activity. While "wait and see" had been the common hedging approach due to uncertainty related to LCFS's survival, the consensus was clearly in favor of surviving the legal challenges all the way up to the Supreme Court. Most felt that even if the SCOTUS rules against LCFS, CARB would be able to modify the program on the fly and the regulatory obligation would continue with minimal modifications.

However due to continued legal threats to the regulation, CARB announced in January that it would freeze 2014 CI levels in line with 2013 levels until early 2015 when CARB finalizes the next iteration of the regulation. The smoothing of the curve in 2015 will result in more aggressive targets from 2016 to 2020, causing significant upward pricing pressure and making current LCFS prices very attractive.

In the March 11th CARB workshop, cost containment mechanisms, including price caps, were discussed, and a follow-on April 4th workshop added a price floor to the conversation. CARB is openly requesting information from low CI fuel producers to help them determine a floor and cap from the perspective of a viable support price for producers.

In summary, the LCFS market is in its infancy and very sensitive to potential regulatory changes. The initial oversupply, combined with CI level freezes and the potential for price caps all contributed to pushing the market down. However, CARB has consistently maintained its commitment to the 2020 targets and confirms its mandate to continue until at least 2030.While current prices are relatively low, upward pricing pressure is on the horizon in the form of higher obligations as of 2016, lower supply due to depressed prices, and increased demand as forward looking obliged parties take advantage of this irresistible hedging environment.