COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY ON THE DRAFT AMENDMENTS TO THE CAP-AND-TRADE PROGRAM TO ALLOW FOR THE USE OF COMPLIANCE INSTRUMENTS ISSUED BY LINKED JURSIDICTIONS

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I.

INTRODUCTION

Southern California Edison Company ("SCE") respectfully submits these comments to the California Air Resources Board ("ARB") on the Discussion Draft of Amendments to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms to Allow for the Use of Compliance Instruments Issued by Linked Jurisdictions ("Discussion Draft"), released on March 30, 2012.[1] SCE appreciates the opportunity to review the ARB staff direction on the draft amendments to link the California cap-and-trade program with the Quebec cap-and-trade program. SCE also thanks the ARB for hosting a workshop on April 9, 2012 ("April 9th Workshop") to discuss the revised regulatory language.

SCE reiterates its concern that the current focus on linking California's yet-untested cap-and-trade program to Quebec's program is diverting resources from the critical task of successfully launching the California cap-and-trade market.[2] A thriving California cap-and-trade program will be a model for similar programs to reduce greenhouse gases ("GHG") throughout the United States and the world. Thus, the ARB's primary focus should be on ensuring a successful auction on November 14, 2012, and a smooth transition to the first compliance period on January 1, 2013, through robust market testing and simulation.

In addition, linking California's program to Quebec's program by allowing compliance instruments to be used across jurisdictions is a substantial and potentially irreversible step. SCE respectfully expresses its concern that the ARB may be rushing into linkage without providing due consideration to the dire consequences that could result in the market if linkage fails or must be reversed in some way. Accordingly, SCE again urges the ARB to consider delaying linkage with Quebec until after the first allowance auction and after the market has had sufficient time to develop.

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1 Discussion Draft, March 30, 2012 (*available at* http://www.arb.ca.gov/cc/capandtrade/draftregquebeclink.pdf).

2 *See* Comments of Southern California Edison Company to the California Air Resources Board on the Cap-and-Trade Workshop; Regulation for Linking California's and Quebec's Cap-and-Trade Programs ("SCE February 2012 Comments"), February 17, 2012, at 1-2.

The ARB must ensure that the California cap-and-trade program is carefully designed and implemented with thorough market testing and simulation, and that the correct regulator is identified. Careful market design is crucial to avoid serious market manipulation and gaming by unscrupulous market players. Negative impacts to the market could include artificial "shortages" of allowances for compliance purposes, "wash trades" of carbon products to temporarily inflate the market prices of GHG allowances and offsets, excessive speculation and unregulated trading in derivatives based on allowance and offset markets, artificial trading in carbon markets with intent to inflate electricity market prices (which are highly correlated to carbon prices), and artificial trading in carbon markets to influence the outcome of long-term electricity contract solicitations. SCE recommends that any regulator of the GHG markets work with the market monitor to track participant activity and enforce remediating and punitive measures when necessary.

II.

THE ARB SHOULD CLEARLY STATE HOW IT COULD REVERSE AND UNWIND ANY LINKAGE WITH QUEBEC

In earlier workshops and comments, SCE identified "de-linking" as an issue for consideration when developing the linkage rules and recommended that the ARB clearly outline the process for addressing changes to either cap-and-trade program that could potentially affect linkage. At the April 9th Workshop, ARB staff stated that in order to disconnect California's cap-and-trade system from Quebec's system, the ARB would have to undergo another rulemaking with a full public process. ARB staff also noted that the ARB has the option of an emergency rulemaking. Although a rulemaking might be the procedural method by which the ARB will de-link the systems, SCE urges the ARB to address the logistical and market implications of disconnecting the two systems. For example, if one program is enjoined, how would a covered entity manage its holdings of allowances from the other system? Is that entity left with worthless allowances? In order to incorporate the risk of losing its allowance value should linkage fail, market participants in California might, for example, trade allowances from

Quebec at a discount to California allowances. In that case, the two systems would never truly be linked and the allowances would not truly be fungible. The ARB's goal of having a fully-linked auction would then collapse, as no entity would be willing to buy an allowance without knowing its specific source. The ARB must carefully consider these market implications and other foreseeable complications that would arise if a linked program needs to be unwound for any reason and adjust its regulation accordingly.

III.

THE REVISED AUCTION PROVISIONS COULD LEAD TO UNDERSUBSCRIBED AUCTIONS, WHICH COULD NEGATIVELY AFFECT THE MARKET AND THE LONG-TERM VIABILITY OF THE CAP-AND-TRADE PROGRAM

SCE commends the ARB's decision to revise the auction schedule to allow Staff and other stakeholders to "perform a number of important activities before [the first real auction], including efforts to maximize stakeholder readiness."[3] SCE looks forward to continuing to work with staff to develop the auction process and participating in the "fully simulated practice auction" to take place in August.[4] However, the new allowance consignment requirements for the sole remaining 2012 auction (scheduled for November 14) are problematic. The current regulation language requires that all investor-owned utilities ("IOUs") submit one-sixth of all allocated 2012 allowances each into the August auction and the November auction. The Discussion Draft combines the consignment volumes for the two auctions in one and requires that each IOU consign one-third of its 2013 allowances to the November auction.[5] This will create a very large supply of allowances in the first auction.[6] An outsized supply, combined with decreasing market confidence in the program, could result in severe undersubscription. As seen in Europe, undersubscription can have significant and serious effects on GHG markets, leading

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[3] Comments of Mary Nichols before the Senate Select Committee on Environment, Economy, and Climate Change, March 27, 2012 (*available at* http://www.arb.ca.gov/cc/capandtrade/nicholstestimony.pdf).

[4] *Id.*

[5] Discussion Draft § 95892, at 126.

[6] In addition, 10 percent of all 2015 allowances will be auctioned in the Advance Auction, increasing the total number of allowances offered on November 14th.

to wild swings in prices and a confusing and inconsistent policy environment for compliance entities. This is not the way for California's cap-and-trade program to begin. Instead, a more reasonable approach would be to require utilities to consign *one-fifth* of their allocated 2013 allowances to auction, since there will now be five auctions for 2013 allowances.

SCE is also concerned about proposed changes to the treatment of IOU-consigned allowances that remain unsold at any auction. In earlier regulation language, these allowances were returned to the utility, to be consigned to auction again within the next budget year.[7] Section 95911of the Discussion Draft provides that the ARB would instead keep these allowances in the general Auction Holding account until the next auction.[8] This could create another oversupply situation that could lead to undersubscribed auctions. In contrast, under the previous rules, utilities could have spread out the re-consignment of unsold allowances over a few auctions.

IV.

THE ARB SHOULD REVISE THE LANGUAGE CONSOLIDATING ACCOUNTS HELD BY ASSOCIATED CORPORATE ENTITIES

Section 95833(e) of the Discussion Draft would consolidate the accounts held by entities that are part of a direct corporate association into a consolidated set of accounts, although the entities could opt out of the consolidation. As the regulatory language currently stands, there are separate accounts for every single registered entity.[9] SCE agrees that in many cases, consolidating accounts would be a simple and reasonable act that could streamline compliance. However, the ARB should provide a different solution for entities such as IOUs that are prevented from sharing information and personnel with those affiliates who are not regulated utilities. The ARB should create a regulatory firewall exclusion, whereby those affiliated companies who are not allowed by regulatory rules to routinely communicate and share

[7] Final Regulation Order § 95911(b)(5)(B), at A-130.
[8] Discussion Draft § 95911(f)(4), at 144.
[9] Final Regulation Order, October 2011, § 95811 at A-47-A-49 (*available at* http://www.arb.ca.gov/regact/2010/capandtrade10/finalrevfro.pdf).

resources would be allowed by the ARB to operate as separate compliance entities in the California cap-and-trade program, with separate accounts and separate holding limits.

Currently, the provisions allowing associated entities to opt out of a consolidated set of accounts do not sufficiently address the problems faced by highly-regulated entities that have unregulated affiliates also participating in the cap-and-trade program. Section 95833(e)(3)(C) of the Discussion Draft states that confirmation of the opt-out decision must "include a distribution of the purchase and holding limits between the consolidated corporate association and any associated entities opting out of consolidation."[10] This language suggests that an IOU and its unregulated affiliates would in some way divide a single Holding Limit between them. SCE strongly objects to this rule.

As SCE explained in detail in its December 2010 comments on the Proposed Regulation,[11] there are long-standing affiliate transaction restrictions imposed upon IOUs by the California Public Utilities Commission ("CPUC") and the Federal Energy Regulatory Commission ("FERC") (collectively, "Affiliate Rules"). The Affiliate Rules create a series of regulatory screens that require a very high level of separation of business activities between regulated utilities (such as SCE) and its unregulated affiliates.

Because SCE may not discuss its participation in the GHG markets, share its forecasts, or coordinate its participation in the GHG allowance auction, SCE cannot share a Holding Limit with its affiliates, nor would the ARB have any reason to enforce one. The ARB should create an exemption to the account consolidation provisions for entities with existing regulated barriers, such as investor-owned electric distribution utilities.

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[10] Discussion Draft, § 95833(e)(3)(C), at 72.

[11] *See,* Comments of Southern California Edison Company to the California Air Resources Board on Its Proposed Regulation to Implement the California Cap-and-Trade Program, December 20, 2010 ("SCE December 2010 Comments"), at 11-14.

V.

WITH THE DELETION OF THE BENEFICIAL HOLDING RELATIONSHIP, THE DISCUSSION DRAFT MAY NOT ALLOW ELECTRICAL DISTRIBUTION UTILITIES TO SATISFY THEIR CONTRACTUAL OBLIGATIONS

In the Discussion Draft, the previous language in Section 95834 allowing Beneficial Holding Accounts has been deleted. Beneficial Holding Accounts were designed to allow electrical distribution utilities to serve as an "agent" to hold compliance instruments on behalf of a "principal" in order to satisfy an electricity contract. SCE agrees that the Beneficial Holding language, as adopted, was problematic and confusing. Although SCE does not object to deleting this language, SCE wishes to highlight earlier concerns about meeting contractual obligations for GHG compliance.

As SCE has explained in previous comments,[12] IOUs such as SCE purchase a large portion of their customers' energy requirements through bilateral contracts with independent power products ("IPP") that require the IOUs to accept the responsibility for the cost of complying with the cap-and-trade program. This could require the IOU to provide compliance instruments to fulfill the IPP's compliance requirements. Thus, IOUs have a significant indirect GHG compliance obligation that is not covered by the Holding Limit. The deletion of the Beneficial Holding language, combined with draft language prohibiting an entity from "acquir[ing] allowances and hold[ing] them in its own holding account on behalf of another entity,"[13] appear to prevent electrical distribution utilities from ever purchasing allowances that could later be transferred to the holding accounts of counterparties in order to satisfy their indirect compliance obligations. IOUs with indirect compliance obligations under existing bilateral agreements (signed before the cap-and-trade regulation was approved) would be unable to satisfy their contractual obligations under the current Discussion Draft regulations.

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[12] SCE December 2010 Comments, at 14-15.
[13] Discussion Draft § 95921(f)(2), at 171.

SCE requests that the ARB consider some other method to allow entities such as SCE to satisfy its preexisting contractual obligations. Below, SCE offers adjustments to the language in Section 95921(f) (General Prohibitions on Trading), in order to clarify that the restrictions on acquiring allowances on behalf of other entities only apply to those situations where the acquisition is an attempt to defraud the holding limit rather than to comply with contractual obligations. SCE provides the following revisions to Section 95921(f):

> (f) General Prohibitions on Trading.
> (1) An entity ~~cannot~~ is prohibited from acquir~~e~~ing allowances and holding them in its own holding account on behalf of another entity or conducting any ~~(2) A~~ trade involving, related to, or associated with any of the following ~~are prohibited~~:
>
> (A) Any manipulative or deceptive device in violation of this article;
> (B) A corner or an attempt to corner the market for a compliance instrument;
> . . .
>
> (2) This Section does not apply to any transfers that investor-owned electrical distribution utilities are required to make to satisfy their contractual obligations to supply compliance instruments to satisfy their counterparties' compliance obligations.

VI.

THE REVISED REGISTRATION AND KNOW-YOUR-CUSTOMER REQUIREMENTS RAISE SERIOUS LOGISTICAL AND PRIVACY CONCERNS

Section 95830 revises some of the requirements for an entity to register with the ARB, introducing additional information about an entity's officers and requiring compliance with the "Know-Your-Customer" requirements outlined in Section 95834.[14] SCE supports the ARB's desire to improve the security and integrity of the tracking system, but cautions that the new provisions may raise logistical difficulties as well as privacy concerns. For example, Section 95830(c) requires a covered entity to provide the names and addresses of the entity's directors and officers, and does not specify whether it is referring to business addresses or personal addresses. Releasing the personal addresses of all the directors and officers of SCE, or its parent

[14] Discussion Draft, § 95834, at 73.

company, Edison International ("EIX"), raises enormous security and privacy concerns. Moreover, for a large, publicly-traded entity such as EIX or SCE, this information is constantly changing. SCE requests that the ARB clarify how often entities would be required to update this information to avoid undue administrative burden for market participants and the ARB.

In addition, Section 95834(b) requires any individual that is given access to the tracking system provide, among other things, the address of his or her permanent residence, birth date, passport numbers, driver license numbers, bank account numbers, all certified by a notary public.[15] Again, although SCE supports the ARB in its efforts to ensure that participants in the tracking system are accurately identified, requiring this level of personal information is too onerous and intrusive, especially for a large, publicly-traded company such as SCE and EIX and does not seem reasonably calculated to lead to the ARB's goal of preventing fraud.

Moreover, to collect this information, the ARB will have to undertake a substantial administrative burden to maintain the privacy of this information, which is protected by statute. California Civil Code Sections 1798 et seq. require state agencies that collect personal information to abide by certain requirements, including notice of data collection and breach, maintenance of records, administrative and physical safeguards, and conditions of disclosure. Similar rules form a patchwork of privacy regulations across the United States that could be triggered for the ARB by individuals trading from outside of California.

The Know-Your-Customer provisions collect an excessive amount of personal information that is unnecessary to accomplish the ARB's goals. SCE recommends that the ARB revise this regulation language to remove the collection of this level of personally identifiable information, especially for representatives of large corporations.

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[15] *Id.*

VII.

THE ARB SHOULD CLARIFY THE LANGUAGE ESTABLISHING ACCOUNT VIEWING AGENTS

Section 95802 of the Discussion Draft proposes new requirements for an "Account Viewing Agent," or "an individual authorized by a registered entity to view all the information on the entity's accounts contained in the tracking system."[16] According to Section 95832(a), each entity is allowed up to five account viewing agents. SCE supports broadening access to the tracking system for each entity. However, this new designation raises questions about the structure of this system and its general accessibility. Specifically, SCE requests that the ARB address two questions. First, how will information that an Account Viewing Agent can access differ from what is available to others that can access the tracking system? Second, how will these requirements affect the treatment of information that entities such as SCE download from the tracking system to local and internal systems? Could these requirements somehow limit the method by which SCE downloads and accesses this information? Answers to these questions will allow entities to better understand and comply with the ARB requirements.

VIII.

THE ARB MUST ADDRESS THE LEGAL AND JURISDICTIONAL ISSUES ASSOCIATED WITH LINKAGE TO A CANADIAN PROVINCE

As SCE has previously noted,[17] creating an international linkage between the California and Quebec cap-and-trade programs could raise a number of significant legal and jurisdictional issues, including: (1) the degree to which the ARB's program will be subject to the control and authority of federal and international laws and regulators, (2) the need to provide program participants with certainty about the identity of the regulators of the secondary and derivatives

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[16] Discussion Draft § 95802, at 3.
[17] SCE February 17 Comments, at 5.

markets that will have the enforcement authority to prevent market manipulation and fraud, and (3) the potential legal challenges to the proposed linked program.

A. Linkage with an International Entity May Subject California's Program to Outside Regulators

First, because the ARB proposes conducting an auction with international and interstate participants, it should be concerned about the intrusion upon and potential dilution of its regulatory authority over the primary market auction. Assuming that allowances and offsets are commodities, state governmental agency sellers or issuers that engage in more than *purely* intrastate transactions could fall within the reach of the federal Commodities Exchange Act's ("CEA's") statutory provisions, the Commodities Futures Trading Commission ("CFTC") (the jurisdiction of the agency charged with enforcing the CEA), or the California Commodities laws embodied in California Corporations Code Sections 29500, *et seq*.[18] Even if some compliance instrument-related products are deemed securities, the ARB would be exempt from the issuer requirements of federal and state securities laws. However, because it will be offering allowances issued by Quebec in its auction, it could be considered a broker dealer with respect to those allowances and could be subject to federal, state, and international trade laws, such as the North American Free Trade Agreement ("NAFTA"), governing broker dealers, as well as antifraud and price manipulation laws for commodities and securities.[19]

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[18] *See, e.g.*, 7 U.S.C. § 2 (1)(a) (broadly defining the jurisdiction of the CEA and CFTC for transactions in interstate commerce.)

[19] *See, e.g.*, Cal Corp Code § 29536 (governing unlawful fraudulent practices in connection with the offering for sale of commodities); Cal Corp Code § 29535 (stating that no person may "act as a commodity merchant [*i.e.*, broker] unless the person (1) is registered or temporarily licensed with the Commodity Futures Trading Commission for each activity constituting that person as a commodity merchant and the registration or temporary license shall not have expired, been suspended, or revoked; or (2) is exempt from the registration by virtue of the Commodity Exchange Act (7 U.S.C. Sec. 1 *et seq*.) or of a CFTC rule.")

B. The ARB Regulations Should Clearly Identify the Regulators and Laws Governing the Secondary and Derivatives Markets

Second, to deter fraud and manipulative practices, the regulations should clearly identify the regulators of and laws governing the secondary and derivatives markets. Most likely, the CFTC will be the regulator for all interstate OTC trades and trades conducted on CFTC-regulated exchanges under the provisions of the CEA. The ARB's regulations should clearly set forth a series of provisions outlining enforcement authority and procedures, as well as potential civil and criminal penalties for fraudulent and manipulative conduct. In addition, if an international program is created and Quebec allowances are traded in the secondary market, reference to the provisions of NAFTA with which allowances holders must comply should be cited in the regulations. The current enforcement language is not sufficiently robust to deter illegal conduct, especially with the complications inherent in creating an international market.

To increase clarity in the program, the ARB should put participants in the derivatives market on notice that they will be subject to the jurisdiction of NAFTA, the CEA, the Dodd-Frank Act,[20] the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as regulations promulgated by regulatory agencies charged with enforcing those laws, including the CFTC and SEC.

C. An International Cap-and-Trade Program Could Raise Legal Challenges

Third, the ARB must carefully consider whether linkage could trigger both state and federal constitutional and statutory challenges to the ARB's authority. Challengers could raise arguments regarding the Supremacy Clause of the United States Constitution requires states to

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[20] *See, e.g.,* 7 U.S.C. § 1a (expanding the definition of swap and commodity to include "all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in."); 7 U.S.C. § § 1a(12), 2 (a), (e), (h), 4(a), 7b-3 (setting forth detailed registration, clearing, reporting, and position limit provisions for swaps).

respect the treaties of the United States, including NAFTA, as the supreme law of the land.[21] The ARB could also face challenges under Dormant Foreign Affairs Power doctrine.[22] To safeguard a successful launch of the California program, the ARB should consider eliminating international participation and limit participation in the primary market auction to California resident entities and out-of-state compliance entities and to only offer ARB-issued California allowances for auction, at least initially.

In sum, the ARB should address the regulatory oversight concerns, enhance the rules governing enforcement of antifraud and manipulative practices, and address the legal authority to create an international market. Overall, the ARB should tailor its regulatory framework to make a successful California program before addressing more ambitious international or national goals.

IX.

THE ARB MUST CONTINUE TO REVISE THE REGULATION TO RESOLVE IMPORTANT ISSUES SURROUNDING ELECTRICITY IMPORTS

SCE recognizes that the ARB is seeking comments on the changes to the cap-and-trade regulation in the Discussion Draft to facilitate linkage with Quebec. Given the importance of ensuring a smooth transition to a successful cap-and-trade program, SCE continues to caution the ARB against dedicating too many of its limited resources to linkage, especially at the expense of ensuring a smoothly functioning California program. A number of important issues relating to electricity imports must still be addressed before the system and the market "go live." For example, the calculation of qualified exports and the definition of resource shuffling are still open and urgent issues that must be addressed before the first auction and the markets begin in

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21 U.S. Const. Art. VI, Cl. 2.

22 U.S. Const. Art. I, § 10, Cl. 1, 2, 3; Art. VI, Cl. 2; United States v. Pink, 315 U.S. 203, 233, 242 (1942) ("In our dealings with the outside world, the United States speaks with one voice.") (Frankfurter, J., concurring); see also Perez v. Brownwell, 356 U.S. 44, 57 (1958) (holding that despite the lack of specific enumeration in the Constitution, there is no doubt as to Congress's power over foreign affairs and that the power is "indispensable" to a sovereign nation and its ability to interact with other nations).

earnest. SCE strongly encourages the ARB to focus its resources on operational, enforcement, and language clarification issues related to imports in the coming workshops.

X.
CONCLUSION

SCE appreciates the opportunity to comment on the Discussion Draft and the April 9th Workshop. SCE looks forward to working with ARB staff to continue to revise the cap-and-trade regulation through the formal rulemaking process in the coming months to achieve a successful California cap-and-trade program.

Respectfully submitted,

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