Proposed Amendments to the Mandatory Reporting Regulation
October 24 ARB Board Meeting
Comments of Morgan Stanley Capital Group Inc.

Morgan Stanley Capital Group Inc. (MSCG) has reviewed the proposed amendments to the Mandatory Reporting Regulation. From the perspective of an overall assessment, we believe the Amendments provide significant improvement to the status quo. In particular, we are gratified by several changes that have been made that are directly responsive to MSCG concerns. That having been said, we do find that a small subset of the proposals are, in our view, misguided, and will result in significant shifting of economic costs and benefits among market participants, for reasons that have nothing to do with the environmental integrity of the Cap-and Trade program.

We believe that one of ARB's overarching principles in developing the rules for the cap-and trade program should be to minimize the impact on commercial activities, and develop and impose only those rules that are required to ensure the environmental integrity of the program. Any rules, standards or interpretations that instead vest economic advantages into particular groups of compliance entities and/or market participants, and are not required for the environmental integrity of the program, should be avoided at all costs. Unfortunately, we believe that certain proposals in the Proposed Amendments miss this mark.

In particular, the crux of our concern, and the main point of disagreement, centers on this quote from the Staff Report: Initial Statement of Reasons, "It is ARB's expectation that the ACS seller controls whether the specified ACS attributes are conveyed with the transaction". To support this viewpoint, the Staff Report goes on to make an analogy with RECs. It is the strongly held view of MSCG that the analogy is inapposite, and that the "expectation" described above is not required to ensure the environmental integrity of the program. Instead, it arbitrarily allocates benefits between market participants (compliance entities that are importers and ACS sellers). Furthermore, indirectly, this allocation of economic value comes at the expense of California consumers, to the extent that it results in higher prices paid by importers who either are compliance entities, or who may sell power to entities who ultimately deliver power to end-use consumers (Investor Owned Utilities, Municipal Utilities, etc.). For these reasons, MSCG strongly urges the Board to reconsider the proposals that stem from this inappropriate assumption about control of attributes, as discussed in more detail below.

<u>Asset Controlling Supplier Issues</u>

MSCG is concerned with clarifications and amendments that enshrine control of whether or not a purchase from an ACS is a "specified" purchase to the sole discretion of the ACS. ARB has developed a clear set of requirements for whether or not a particular import meets the criteria for being from a specified source. At the core, these requirements are 1) written contract 2) identification of the resource in the contract 3)

direct delivery to California. Further, with regard to an ACS specifically, ARB has proposed an amendment in the definitions (#20) that states unambiguously that "Asset Controlling Suppliers are considered specified sources". We believe that the 3 core criteria and the clarification proposed in the definition are entirely appropriate with regard to the determination of whether or not a transaction can be considered and reported as "specified". Yet part of the proposed amendments includes the proposed "clarification" that an ACS controls whether or not a sale is specified. This additional criterion provides absolutely no improvement to the environmental integrity of the cap-and trade program, and contradicts other parts of the regulations. Conversely, it can be construed as unwarranted interference in negotiating and contracting activities outside the state of California. Furthermore, it swings the determination of whether or not power can be reported as "specified" based solely on whether or not the seller deigns to use the word "specified", rather than on any intrinsic aspect of the underlying electricity being contracted for or the type of transaction used. Last, but not least, granting this type of arbitrary overlordship over how a transaction is reported to ARB to the seller, rather than to the buyer/importer, has the potential to raise the cost of power to California consumers.

To see why this is so, consider the following transaction. Buyer X negotiates a purchase from an ACS. The transaction will have a written contract, and Buyer X intends to direct deliver the power to California. All of the details are negotiated except the price. For this final detail, the ACS says "if you want us to say the transaction is specified, the price is an extra $6/mwh". Regardless of which option Buyer X elects, the 3 core requirements of a specified source purchase will have been met. The physical dispatch of the ACS' system will be unchanged. In what way will the ability of the ACS to arbitrarily charge a premium for the "service" of stating for the record that the purchase is specified, improve the environmental integrity of the program? Clearly, the answer is that it will not. Therefore, what rationale can ARB have for interfering in commercial negotiations where no issue of environmental integrity is at stake? Even worse, why would ARB want to take such a position when it ultimately, if indirectly, takes money out of the pockets of California consumers?

Last but not least, granting this kind of ability to arbitrarily deem some transactions to be specified and others not, especially when combined with the new "path out" ability to deem some ACS power sales as "surplus", facilitates Resource Shuffling -- the physical dispatch is unchanged, but the degree of emissions attributed to California consumption varies at the whim of the seller. Therefore, if anything, granting an ACS the ability to arbitrarily designate transactions as specified or not degrades the environmental integrity of the program.

MSCG will speculate that some of the concerns that may have driven this decision are valid, although we believe that the solution is misguided. Issue one is whether or not power bought from an ACS on an exchange can be treated as specified. We agree with the philosophy that this type of transaction does not meet the criteria for a specified transaction regardless of how it is e-tagged. However, it is not necessary to give an ACS (or any other type of seller, for that matter) arbitrary control of designation of transaction type to make this clear. The exact wording used could be constructed in many ways, but the basic concept would simply be something like "transactions originally consummated via exchange, broker or other intermediary, where the seller and buyer do

not initially know who they are contracting with, do not meet the criteria for "specified source" transactions regardless of how they are tagged or delivered to California".

Issue two would be related to "detached" sales. MSCG strongly argues that any and all sales by an ACS that originate from an ACS Balancing Authority should be ACS system sales. We do not support the idea that some sales can be "system" and some "surplus", as this ability is both fundamentally inconsistent with the underlying concept of an ACS on a per se basis, and because it facilitates Resource Shuffling. It is also inconsistent with the calculation methodology for determination of the ACS emission rate, as that calculation includes a factor for purchased power. That said, we would support the idea that sales from points physically detached and remote from an ACS system or Balancing Authority should not be considered ACS sales. For example, consider a hypothetical ACS located in the Pacific Northwest that has a marketing arm which, at times, offers power for sale at Palo Verde. We would agree that the most reasonable interpretation would be for such sales to not be considered as being from an ACS portfolio, if the source of the generation does not originate from the ACS system or Balancing Authority. However, the way to make this distinction is not to allow the ACS to arbitrarily deem some sales to be "system" and some to be "surplus", but rather to geographically define the parameters of the ACS and deem all sales physically originating from within the ACS host Balancing Authority to be "system" sales and any sales originating from outside the geographic footprint to be "non-system". Once determined, this distinction should be applicable at all times - -an ACS should not be able to vacillate back and forth, and an ACS must not be permitted to artificially reduce the carbon intensity of either specified or unspecified energy by first importing this energy to its Balancing Authority and "regenerating" it as ACS power for delivery to California.

Nine months of real world experience with the Cap-and-Trade program have seen significant shifts in market activity attributable solely to the ACS status of certain entities (as opposed to the implementation of the Cap-and-Trade program itself). ACS entities can import specified or unspecified power and "sink" it in their host Balancing Authority (either directly or through an intermediary system) and then "regenerate" ACS power for direct delivery to California. California receives "low carbon" ACS power and the ACS importer is not required to retire carbon allowances, but clearly there has been no change in the overall carbon intensity of the generation, in aggregate. These shifts have lead to widespread suspicion among market participants that ACS entities may be abusing the ACS process to "launder" dirty power. The best way to dispel (or confirm) this suspicion is through the most well-known disinfectant: sunshine. To this end, we reiterate two requests frequently made in prior commenting opportunities. First, we believe that the regulations should include a detailed narrative description of the philosophical underpinnings of the ACS program. Absent this benchmark, market participants have no standard against which to evaluate the appropriateness, or lack thereof, of any particular rule, regulation, practice or formula governing ACS activity. Second, we believe the details of all ACS emission rate calculations should be made public, so market participants can review and critique the results. In particular, market participants, with their expertise and "market intelligence", may be well placed to identify issues, problems and abuses that ARB staff, without either market experience or market presence, could not reasonably be expected to identify. For these reasons, we strongly believe that the

ongoing integrity of the cap-and trade program requires much greater transparency surrounding all aspects of the ACS program.

Based on that overarching philosophical discussion, MSCG believes ARB should take the following specific actions with regard to the proposed Amendment language:

I. S. 95111(a)(4)

(4) *Imported Electricity from Specified Facilities or Units.* The electric power entity must report all direct delivery of electricity as from a specified source for facilities or units in which they are a generation providing entity (GPE) or have a written power contract to procure electricity. When reporting imported electricity from specified facilities or units, the electric power entity must disaggregate electricity deliveries and associated GHG emissions by facility or unit and by first point of receipt, as applicable. The reporting entity must also report total GHG emissions and MWh from specified sources and the sum of emissions from specified sources explicitly listed as not covered pursuant to section 95852.2 of the cap-and-trade regulation. The sale or resale of specified source electricity is permitted among entities on the e-tag market path insofar as each sale or resale is for specified source electricity in which sellers have purchased and sold specified source electricity. Starting with the initial purchaser, each seller must warrant the sale of specified source electricity from the source through the market path.

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This slight change is necessary to make it clear that the job of establishing the qualification of a transaction as "specified" rests with the initial purchaser, who must meet all of the requirements. Unchanged, the text would imply that the initial seller must warrant that the sale qualifies as "specified". As described in more detail in our prior argument, MSCG strongly believes that the seller should have no role in establishing that fact.

II. S. 95111(a)(5)(E)

(E) *Tagging ACS Power*. To claim power from an asset-controlling supplier, the asset-controlling supplier's Balancing Authority Area must be identified as the source on the physical path of the NERC e-Tag and the asset-controlling supplier as the PSE at the first point of receipt, or in the case of asset controlling suppliers that are exclusive marketers, the associated generation owner's Balancing Authority Area must be shown as the source on the NERC e-Tag and the asset controlling supplier as the PSE immediately following the associated generation owner.

Deleted: . with the exception of path-outs. Path-outs are excess power originally procured as part of a U.S. federal mandate to serve the operational or reliability needs of a U.S. federal system but which are no longer required due to changes in demand or system conditions.

As described in our detailed argument, an ACS should not be able to deem some of its power "surplus". Subject to our comments about "megawatt laundering", purchased power where the asset controlling supplier's Balancing Authority Area is the point of delivery on the E-Tag should already be accounted for in the calculation of the ACS assigned emission factor. Allowing exceptions for "path outs" or other forms of segregation both facilitates Resource Shuffling and is inconsistent with the calculation methodology of the ACS emission factor.

III. S. 95111(a)(5)(B)

(B) :

Deleted: Report delivered electricity as specified and not as unspecified.

Deleted: Report asset-controlling supplier power that was not acquired as specified power, as unspecified power

MSCG believes that the language above is problematic from multiple perspectives. First, it is tautological without being informative. It would appear to go without saying that one should not report power that does not meet the requirements to be reported as specified power as unspecified. So, the language is sort of pointless. Second, even assuming that the statement needs to get made, as drafted, it does nothing to define exactly what constitutes "acquired as specified".

Our assumption is that the intent behind this language was aimed at one or perhaps two sets of circumstances. First would be to establish that "the ACS seller controls whether the specified ACS attributes are conveyed with the transaction". As previously discussed at great length, MSCG strongly opposes the precept, and for that reason alone, advocates that the text above be completely eliminated. Although previously discussed primarily in the context of the ACS having control, the same issue can arise with a non-ACS supplier. Although there is nothing in the Staff Report that expresses an intent to grant that type of control to non-ACS suppliers, the language as drafted could be interpreted as doing so. MSCG opposes this granting of control to a non-ACS seller just as strongly as we oppose it for an ACS.

Second, the intent might be to address the concept that power first purchased through an intermediary can't meet the requirements of a specified power purchase. We support this interpretation of the regulation, but believe the language above does not accomplish the objective. There are many formulations that could clearly address this objective. For convenience, repeating from our detailed argument above, one reasonable option might be "transactions originally consummated via exchange, broker or other intermediary, where the seller and buyer do not initially know who they are contracting with, do not meet the criteria for "specified source" transactions regardless of how they are tagged or delivered to California".

System Power

The Proposed Amendments introduce a new concept called "system power", which appears to be something different from ACS power. As we understand it, this situation would arise under ARB's own initiative, rather than when a "system" applied for the designation. The intent appears to be to better align actual emissions with reported emissions, when a "system" has an emission rate above the default emission rate, and would thereby have no reason to sell any power as "specified".

MSCG has no objections to the concept. However, there is one significant concern with the practical implementation. A party may have entered into a contract, in good faith, under the existing rules. In that situation, the economic balance of the contract would most likely have been based on the assumption that the attributable emissions of the transaction would be the "default" rate. For ARB to, after the fact, declare a transaction from a certain "system" to be assigned an emission factor higher than the default rate would be

inequitable. Therefore, the new system power regulations need to include a "grandfathering" clause for contracts in place prior to the posting of the relevant "system power" emission factor on the ARB web site. Contracts in place would not be affected, and the new system power rate should only apply to any contract entered into after the effective date of the new rate. To do otherwise will recreate in a different guise the "Legacy Contract" issue that is addressed in the companion Proposed Amendments to the Cap and Trade Regulation.

Guidance Documents

MSCG appreciates the ARB's ongoing ancillary effort to provide guidance documents that help market participants interpret the regulations, as they apply to practical everyday situations. It occurred to us that, with regard to electricity market transactions, a matrix chart showing how all transaction types fit into the various reporting categories would be convenient and very useful. To that end, we have devised a recommended chart that we would like to see ARB adopt as part of its guidance document collection (see below);

Term of Contract:	**How it was transacted:**	**Reported Carbon Treatment:**	**Justification:**
Forward; delivery is greater than 1 week out	On exchange (ICE) or anonymously through broker Written confirm generated by both counterparties and broker.	Unspecified emission rate	Parties did not know the source of the generation when the transaction was completed.
Forward; delivery is greater than 1 week out	Transacted directly between counterparties. Standard WSPP rules require written confirm.	If source is agreed to for the contract: Specified emission rate If source is not agreed to for the contract: Unspecified emission rate (for ACS see below) ACS power - If power is generated from facilities located inside ACS	Meets specified contract requirements For example: power transacted at a hub like Mid C or PV where the generation can come from a variety of sources If the power is generated from sources with an ACS balancing

		balancing authority: Specified ACS emission rate ACS power – if the source of the generation does not originate from the ACS system or balancing authority boundary: Unspecified or specified if source is named.	authority, the buyer should be able to claim ACS specified rate. If ACS owner does not wish to sell their power this way, they can sell it on an exchange or bi-laterally to avoid this situation. Consistent with original premise of ACS. For example, if an ACS from the Pacific Northwest, sells power at Palo Verde. There is no geographic link between ACS and the source of the power. Power is not coming from ACS balancing authority so ACS rate should not be claimed.
Day Ahead Transactions (Pre-schedule transactions up to a week)	On exchange (ICE) or anonymously through broker	Unspecified emission rate	Parties did not know the source of the generation when the transaction was completed.
Day Ahead Transactions (Pre-schedule transactions up to a week)	Transacted directly between counterparties (pursuant to an underlying umbrella master written agreement (i.e. WSPP)) E-tag is the written confirmation for specified source documentation	If source is agreed to for the contract: Specified emission rate If source is not agreed to for the contract: Unspecified emission rate (for ACS see below)	Meets specified contract requirements For example: power transacted at a hub like Mid C or PV where the generation can come from a variety of sources

		ACS power - If power is generated from facilities located inside ACS balancing authority: Specified ACS emission rate ACS power - if the source of the generation does not originate from the ACS system or balancing authority boundary: Unspecified or specified if source is named.	If the power is generated from sources with an ACS balancing authority the buyer should be able to claim ACS specified rate. If ACS owner does not wish to sell their power this way, they can sell it on an exchange or bi-laterally to avoid this situation. Consistent with original premise of ACS. For example, if an ACS from the Pacific Northwest, sells power at Palo Verde. There is no geographic link between ACS and the source of the power. Power is not coming from ACS balancing authority so ACS rate should not be claimed.
Real Time Transactions– next hour or balance of day delivery	On exchange (ICE) or anonymously through broker	Unspecified emission rate	Parties did not know the source of the generation when the transaction was completed.
Real Time Transactions– next hour or balance of day delivery	Transacted directly between counterparties (pursuant to an underlying umbrella master written agreement (i.e. WSPP))	Specified emission rate of the source on the E-tag.	Parties should agree to the source of the generation at time of transaction because E-tag needs to be generated imminently.

	E-tag is the written confirmation for specified source documentation	ACS power generated from facilities located with the ACS balancing authority should be reported at the specified ACS rate.	ACS should not be able to pick and choose who gets to report what carbon attributes. That harms the environmental integrity of the program. The true source emissions should be reported.

MSCG appreciates the opportunity to provide our views to ARB with regard to the Proposed Amendments. For any follow-up communications, please contact Steve Huhman at (914) 225-1592, or via e-mail at Steven.Huhman@morganstanley.com.