CP Energy Marketing (US) Inc.
Suite 1200, 401 – 9th Avenue S.W.
Calgary, AB T2P 3C5
Canada
www.capitalpower.com

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Submitted electronically to http://www.arb.ca.gov

California Air Resources Board
1001 "I" Street
Sacramento, CA 95814

To Whom it May Concern:

Re: Comments of CP Energy Marketing (US) Inc. on ARB Cap and Trade Regulations

CP Energy Marketing (US) Inc. ("CPEMUS") appreciates the opportunity to provide comments to the Air Resources Board ("ARB" or "Board") on its *Proposed 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*.[1]

CPEMUS believes that the success of the cap and trade program depends on creation of the broadest and most vibrant possible market. Time and time again, markets throughout the world have proven that an increase in the number of participants increases liquidity and drives greater efficiency. A robust and successful market can be achieved only if the rules and regulations are sufficiently clear that prospective market participants understand what actions can be undertaken without subjecting the participant to unreasonable and unintended regulatory risk.

In these comments, CPEMUS focuses on two aspects of the Board's proposed regulations: (1) actions undertaken in the secondary market in the context of Section 95921, Conduct of Trade, and particularly subsection (f), General Prohibitions on Trading; and (2) communications with and by auction advisors within the context of Section 95914, Auction Participation and Limitations. With respect to both of these issues, CPEMUS seeks clarification that transactions undertaken in good faith, for legitimate business reasons, that do not violate holding limits, and

[1] Posted May 9, 2012, http://www.arb.ca.gov/regact/2012/capandtrade12/capandtrade12.htm

without any intention to engage in a trick, scheme, fraud or artifice, will not trigger liability on behalf of market participants. CPEMUS has proposed (in Attachment A) revised regulatory language for the Board to consider. Whether or not the Board elects to modify the regulatory text, it is critical that the Board provide guidance and clarify whether the various actions described below are permissible.

1. THE BOARD SHOULD CLARIFY THAT PRIVATE TRANSACTIONS DO NOT VIOLATE THE PROHIBITIONS ON TRADING.

CPEMUS supports the modifications made to the regulations clarifying prohibitions on trading. However, CPEMUS submits that further modifications are necessary to clarify that commercial transactions undertaken in the secondary market for valid business purposes do not violate the prohibition on acquiring allowances and holding them for the account of another entity.

Section 95921(f)(1) of the proposed regulations, "General Prohibitions on Trading," has been modified to state:

> "An entity cannot acquire allowances and hold them in its own holding account on behalf of another entity."

Despite this language, it appears clear that the Board anticipates that parties will be free to buy and sell their compliance instrument on the secondary market. For example, one section of the preamble (specifically, page 22 of the "Summary of Proposed Action" section) states that "Entities may enter into private transactions agreements, but the account system does not recognize the transaction until the account administrator receives valid transfer requests."

CPEMUS believes that the prohibition on trading is intended to work in tandem with the holding limit set out in Section 95920 to prevent an entity from holding compliance instruments for the purpose of enabling another entity to avoid the holding limits. CPEMUS believes that the prohibition is not intended to bar the types of arms' length commercial trading transactions routinely undertaken in market environments. However, the proposed regulations do not make any such distinction. CPEMUS therefore requests that the Board modify the regulations as proposed below, or specifically provide guidance as to what constitutes the prohibited conduct of "acquir[ing] allowances and hold[ing] them in its own account on behalf of others," as opposed to engaging in legitimate transactions such as long term contracts to buy and sell allowances.

To facilitate the Board's consideration of this matter, CPEMUS offers three specific scenarios for consideration:

Scenario 1.

Company X intends to buy and sell compliance instruments for its own holding account on a routine basis. Company Y is an industrial company and wants certainty in its compliance costs for future years. Company X enters into an agreement with Company Y to sell Company Y compliance instruments at $50/allowance in January 2013, and other compliance instruments for $55/allowance in January 2014. Company X enters into similar arrangements with other third parties, including Company Z, at various prices and quantities. Company X purchases and holds at least a portion of the compliance instruments needed to satisfy its contractual obligations, and purchases additional compliance instruments as necessary on the open market near the compliance deadline. When the obligations to provide compliance instruments to Company Y arise under the agreement, Company X and Company Y properly transfer the compliance instruments between accounts pursuant to Section 95921 of the proposed regulations.

Scenario 2.

Company A owns a fruit and vegetable canning facility subject to compliance obligations under the regulations. Company B enters into a "tolling" style arrangement for up to fifty percent of the facility's capacity for a five year term, under which Company B provides to Company A all fruit and canning supplies and owns the final product. The tolling arrangement requires Company B to provide its proportionate share of Company A's compliance obligation. Company B purchases and holds in its account compliance instruments in anticipation of its obligation to provide its share of compliance instruments to Company A. When the obligations to provide compliance instruments to Company A arise under the agreement, Company A and Company B properly transfer the compliance instruments between accounts pursuant to Section 95921 of the proposed regulations.

Scenario 3.

Company J has independently analyzed the market for compliance instruments and believes the market value in 2015 will be between $50-$60/instrument. Company K separately analyzes the market, and concludes the range will be $55-$65 per instrument. Company L separately analyzes the market and expects the value range to be $65-$70 per instrument. Company K contractually agrees to sell compliance instruments to Company L for $61/instrument, delivery to take place prior to Company L's 2015 compliance obligation under the regulations. Six months later, Company K agrees to purchase compliance obligations from Company J at $62 per instrument. Company K holds the instruments in its account, pending delivery to Company L in 2015. When the obligations to provide compliance instruments arise under the agreements, the companies properly transfer the compliance instruments between accounts pursuant to Section 95921 of the proposed regulations.

In each of these scenarios, the parties involved are trading on the basis of their own knowledge, and purely for their own economic self-interest. No entity is attempting to corner the market, and no entity has engaged in any artifice of fraud or other behavior normally considered problematic in regulated markets. No entity is transacting in a manner that circumvents the holding limit requirements. In each case, every party involved has entered into the transaction in good faith and for legitimate business purposes.

CPEMUS urges the Commission to expressly state that each of these transactions is permissible under the regulations, or modify the regulations to make this fact clear. In particular, CPEMUS recommends that Section 95921(f)(1) be modified to state: "An entity cannot acquire allowances and hold them in its own holding account on behalf of another entity for the purposes of avoiding the holding limit set forth in Section 95921(a)."

2. THE BOARD SHOULD CLARIFY THAT RECEIPT BY AN AUCTION ADVISOR OF CONFIDENTIAL INFORMATION FROM MORE THAN ONE MARKET PARTICIPANT DOES NOT CREATE A *PER SE* VIOLATION OF THE REGULATIONS.

The Board's proposed regulations clearly contemplate that some entities will use advisors in developing their bidding strategy.[2] The regulations therefore demonstrate that the Board recognizes the importance of allowing entities subject to compliance obligations to reach out and acquire needed expertise through professional advisors that understand the market and the regulatory requirements. Transacting in carbon markets that span international boundaries can be complex and confusing. Although some market participants, such as the large utilities eligible for cost recovery, may be able to build the internal expertise to fully understand and track the market, other participants, such as the smaller industrial companies, will need to seek the assistance of advisors to understand and navigate the market. Such advisors will need to invest time and energy in understanding the market and developing market analytics, the cost of which must be spread over multiple clients.

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[2] The Board is proposing to modify the confidentiality provisions in Section 95914(c)(1) to make it clear that an auction participant may provide confidential information to an advisor (emphasis supplied):

> "***Unless it is to an auction advisor*** or other members of a direct corporate association not subject to auction participation restriction or cancellation pursuant to section 95914(b), an entity approved for auction participation shall not release any confidential information related to its auction participation."

Section 95914(c)(2) of the regulations states:

> (2) If an entity participating in an auction has retained the services of an advisor regarding auction bidding strategy, then:
>
> > (A) The *entity must ensure against the advisor transferring information* to other auction participants or coordinating the bidding strategy among participants;
> >
> > (B) The entity will inform the advisor of the prohibition of sharing information to other auction participants and ensure the advisor has read and acknowledged the prohibition under penalty of perjury; and
> >
> > (C) Any entity that has retained the services of an advisor must inform ARB of the advisor's retention.

(Emphasis supplied).

Although Section 95914(c)(2) does not prohibit an advisor from serving more than one market participant at a time, it does not, on the other hand, expressly permit such arrangements. CPEMUS requests that the Board revise the language of the regulations to clarify that an advisor can serve multiple market participants simultaneously.

CPEMUS believes the requirement that an entity disclose to the Board that it has retained an advisor, as set forth in Section 95914(c)(2)(C), is wholly appropriate, and should be retained. However, CPEMUS submits that the Section 95914(c)(2)(A), which requires an auction participant to *ensure against certain actions by the advisor*, should be revised to eliminate such responsibility on the part of market participant. The regulations already prohibit the advisor itself from transferring information improperly or coordinating bidding efforts. Adding to that prohibition the specter that an auction participant will be at risk of regulatory violations for the actions of a third party advisor will serve only to inhibit the willingness of market participants to obtain the services of advisors that understand the market and its requirements. As a result, it will detract from, rather than encourage, a well-functioning market in which knowledgeable parties transact on a level playing field. The Board should clarify the regulations to ensure that only the advisor itself, and not market participants, are accountable for any violations of the regulations by the advisor. Such a clarification will provide an incentive for advisors to understand and follow the regulations, while at the same time providing market participants with security that they will not have vicarious liability for the actions of third parties. In this way, advisors serving multiple

participants will be responsible for ensuring protection of confidential trading information and compliance with the regulations.

3. THE BOARD SHOULD CLARIFY THAT A MARKET PARTICIPANT MAY CONCURRENTLY SERVE AS AN ADVISOR.

CPEMUS believes that the Board should clarify that -- assuming no indication of misconduct of the kind generally prohibited with respect to trade, as set forth in Section 95921(f)(2) -- an entity may function simultaneously both as an advisor and as a market participant. As an example, assume one small company with compliance obligations – perhaps a cement manufacturer – elects to invest the time and expense in training of an employee with respect to the carbon trading markets. That entity may be able to share some costs by making its employee available to advise a second company, defraying compliance costs for both. To the extent that neither entity exceeds its holding limit, that there is no attempt to corner the market, and that the advisory relationship is reported to the Board, as required by Section 95914(c)(2)(C), there is little risk of market manipulation or gamesmanship. Rather, the market benefits by having informed participants and California-based businesses benefit from reduced compliance costs.

As another example, CPEMUS anticipates that industrial entities with compliance obligations may desire to use third-party advisors to help meet their A.B. 32 compliance obligations in much the same manner as many already use third-party aggregators to help meet their electric power needs. As with California's successful Energy Service Supplier mechanism, such an approach can allow an industrial entity to offset its risk and avoid the need to add expertise in a field not otherwise part of its core business. However, such third-party advisors may be required to purchase compliance certificates to meet contractual obligations, and may therefore themselves be market participants. In order to provide market participants with certainty that they may rely on informed advisors that may also be market participants, the Board should clarify that, barring any violation of Section 95914 or Section 95921, persons may simultaneously act as advisors and be market participants.

4. CONCLUSION

CPEMUS respectfully requests that the Board:

(1) amend its regulations to clarify that market participants may engage in arm's length transactions in the secondary market provided that such transactions are not done to avoid the holding limits as set forth in Section 95921(a);

(2) clarify that receipt by an auction advisor of confidential information from more than one participant does not create a per se violation of the regulations; and

(3) clarify that a market participant may concurrently serve as an auction advisor, provided that no party involved is engaged in activity proscribed by the regulations. Such amendments are necessary in order for market participants to have comfort that participation in the market will not subject them to regulatory liability beyond their ability to control.

In the alternative, to the extent the Board declines to modify its regulations, it should specifically find that the various transactions described above are consistent with the regulations as currently drafted, or provide specific delineation and examples of transactions that may be undertaken without subjecting an entity to potential regulatory liability.

CPEMUS appreciates the opportunity to provide comments in connection with this matter and thanks the Board for its consideration of our comments.

Sincerely,

CP ENERGY MARKETING (US) INC.

Per: _____

Zoltan Nagy-Kovacs
Senior Legal Counsel

Appendix A

Proposed Amendments to Regulations[3]

Section 95914(c)(2)

(2) If an entity participating in an auction has retained the services of an advisor regarding auction bidding strategy, then:

> (A) ~~The entity must ensure against the advisor transferring information to other auction participants or coordinating the bidding strategy among participants;~~
>
> ~~(B)~~ The entity will inform the advisor of the prohibition of sharing information to other auction participants and ensure the advisor has read and acknowledged the prohibition under penalty of perjury; and
>
> ~~(C)~~ **(B)** Any entity that has retained the services of an advisor must inform ARB of the advisor's retention.

Section 95921(e)(f) General Prohibitions on Trading.

(1) An entity cannot acquire allowances and hold them in its own holding account on behalf of another entity ***for the purpose of avoiding the holding limits as set forth in Section 95921(a)***.

[3] **Additions shown in *bold italics*, deletions shown as ~~strikeout~~.**