COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY TO THE CALIFORNIA AIR RESOURCES BOARD ON THE 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, RELEASED MAY 9, 2012

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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") appreciates the opportunity to comment on the California Air Resources Board's ("ARB's") *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*, released May 9, 2012, and the "Staff Report: Initial Statement of Reasons" ("ISOR")[1] explaining the proposed changes. ARB staff released two versions of the Proposed Regulation Order on the ARB website.[2] One Proposed Regulation Order includes general changes to the regulation without any provisions for linkage with Québec. The other, listed on the website as the Proposed Regulation Order for Linkage, includes additional changes made for a proposed linkage rulemaking.

Below, SCE provides detailed comments and suggestions on linkage to Québec, the auction process, registration and accounts, conduct of trade, and electricity imports.

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[1] California Air Resources Board, *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*, "Staff Report, Initial Statement of Reasons" ("ISOR"), May 9, 2012, *available at* http://www.arb.ca.gov/regact/2012/capandtrade12/isormainfinal.pdf.

[2] ARB staff released two versions of the Proposed Regulation Order. Appendix A.1 to the ISOR contains a "Proposed Regulation Order" and is available at http://www.arb.ca.gov/regact/2012/capandtrade12/appendixa1.pdf. Appendix A.2 to the ISOR contains an alternate "Proposed Regulation Order" which is linked to on the ARB website as the "Proposed Regulation Order for Linkage." Appendix A.2 incorporates the changes in Appendix A.1, and is available at http://www.arb.ca.gov/regact/2012/capandtrade12/appendixa2.pdf. For purposes of simplicity, SCE's comments will refer and cite to the more inclusive Proposed Regulation Order for Linkage in Appendix A.2.

II.

EXECUTIVE SUMMARY

SCE compliments ARB staff for continuing to work closely with SCE and other stakeholders to adjust and improve the cap-and-trade program through workshops and other informal stakeholder meetings. SCE has communicated some of the concerns outlined below in earlier comments to the ARB, including comments on the Discussion Draft released earlier this year.[3] Because those documents were not part of a formal rulemaking process, SCE repeats some of its earlier remarks here for the record.

SCE supports the use of broad and efficient markets to achieve the goals of Assembly Bill ("AB") 32. The ARB must ensure that the California cap-and-trade program is carefully designed and implemented to ensure the establishment of a fair and transparent market. Meticulous market design and implementation are crucial to avoid market power scenarios and market manipulation that will challenge the efficient operation of the allowance and electricity markets and increase the economic burden on California. ARB has an obligation to provide sufficient time to properly simulate and test the market design in order to ensure that attempts to manipulate the allowance or derivative markets in electricity or other commodities are mitigated. Appropriate market design and testing will prevent strategies such as those designed to create artificial "shortages" or inflated prices of compliance instruments, and, potentially more harmful, inflated prices in the electricity markets (which are strongly affected by carbon prices). Such manipulation will not only challenge the integrity of the allowance markets and increase customers' electricity costs, but threaten public

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[3] 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 Jurisdictions, April 13, 2012, *available at* http://www.arb.ca.gov/lists/april-9-draft-reg-ws/15-2012-04-13_sce_comments_on_linkage_and_discussion_draft.pdf; 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, February 17, 2012, *available at* http://www.arb.ca.gov/lists/feb-3-link-wci-ws/10-sce_comments_to_carb_on_quebec_linkage_workshop_final.pdf; Comments of Southern California Edison Company to the California Air Resources Board on the Public Meeting to Discuss Compliance Requirements for First Deliverers of Electricity, Held May 4, 2012 ("SCE May 4 Imports Comments"), May 11, 2012, *available at* http://www.arb.ca.gov/lists/5-4-electricity-ws/13-2012-05-11_sce_comments_on_electricity_imports_workshop.pdf.

support for AB 32 and its goals. In order to prevent these economic and political impacts, the ARB must refocus its efforts and resources on market implementation and monitoring.

While SCE agrees with the ARB that creating a broader cap-and-trade program through linkage is a worthy goal, SCE strongly urges the ARB to postpone linkage activities until the California cap-and-trade program is successfully launched. Specifically, SCE respectfully submits that the ARB should prioritize its work efforts to ensure that the California systems, processes, and controls are not only adequate but robustly tested to prevent a failed first auction or market launch with possibly disastrous consequences.

SCE's recommendations regarding the Proposed Regulation Order are provided below in Sections III to VIII. SCE's detailed comments will focus on the following points.

- **Market readiness should be the ARB's first priority**. The ARB's proposal to link to Québec does not adequately consider the resources needed to successfully launch California's greenhouse gas ("GHG") market. SCE urges the ARB to instead direct its resources to ensure readiness, including documented procedures, processes, controls, and thorough market testing via simulations and test auctions.
- **It is premature to link to Québec and other jurisdictions.** SCE reiterates its recommendation that, when the time comes to address linking to another jurisdiction such as Québec, the ARB should also develop regulation language that addresses any potential "de-linking" with Québec or any other linked jurisdiction. SCE also notes that linkage with an international entity may subject California's program to outside regulators.
- **The ARB must address electricity imports so that California electricity customers are not burdened with additional costs.** SCE continues to have significant concerns regarding the treatment of electricity imports, specifically the serious market-altering consequences that would result from a gap in the ARB's jurisdiction over out-of-state importers of electricity. In addition, the ARB should address the definition of resource shuffling, the qualified exports ("QE") adjustment, and ensure regulatory consistency with the Renewables Portfolio Standard ("RPS").

- **Further changes are needed to ensure a smooth auction process.** SCE recommends additional changes to improve the amended auction provisions, including:
    - Clarifying language regarding confidential bid information to ensure that regulated entities such as SCE may share confidential bid data with the California Public Utilities Commission and other regulators, as needed;
    - Consigning only one-fifth, rather than one-third, of the allocated allowances to the November 2012 auction;
    - Informing market participants when the ARB withdraws allowances from certain accounts for consignment to future auctions to provide for greater market transparency; and
    - On the revised auction format provisions, (a) setting the auction reserve price in only one currency to avoid penalizing compliance entities in jurisdictions with weaker currencies; (b) settling tie bids in a proportional manner as suggested in the Proposed Regulation Order for Linkage; and (c) clarifying the language describing the amount of the bid guarantee.
- **Flexibility is needed in the provisions regulating registration and accounts.** In the Proposed Regulation Order for Linkage, ARB staff proposed regulatory amendments addressing compliance entity registration and accounts. The proposed registration and Know-Your-Customer requirements have serious logistical and privacy implications, and SCE has strong concerns as to whether the ARB can adequately protect confidential business information. Finally, the ARB should simplify the designation of authorized account representatives to avoid confusion.
- **Conduct of trade provisions should be improved.** The Proposed Regulation Order for Linkage contains a number of amended provisions governing the conduct of trade. SCE strongly advises that the newly-introduced "push-push-pull" system for confirming transfer requests refer to business days, and that the ARB should allow two business days for the "pull" from the transfer recipient. The ARB should permit compliance entities to directly

transfer compliance instruments to another entity's compliance account. In addition, the price reporting requirements should be adjusted in order to gather meaningful data. For market monitoring and transparency purposes, the ARB should design and distribute data publication rules and principles. Moreover, with the removal of beneficial holding relationships, regulatory amendments are necessary to allow electrical distribution utilities to satisfy their contractual obligations.

III.

THE ARB SHOULD CONSIDER LINKAGE ONLY AFTER THE CALIFORNIA CAP-AND-TRADE PROGRAM HAS BEEN SUCCESSFULLY LAUNCHED

The ARB must lay the foundation for the success of California's program *before* linking to Québec or any other jurisdiction. Linking California's yet-untested cap-and-trade program to Québec's program is diverting limited ARB resources from the critical task of successfully launching the California cap-and-trade market. SCE commends the ARB for its plan to conduct a practice auction in advance of the first live auction scheduled for November 2012, as a mock auction is a crucial step in discovering flaws in the compliance instrument tracking and auction systems. Still, SCE is concerned that a single test auction will adequately test neither the baseline functionality and reliability of these systems and processes, nor the ARB's ability to impose its regulatory control on these systems. Moreover, the limited scope of the one planned practice auction excludes allowances consignment and bid guarantee submissions and is not fully integrated with the ARB's compliance instrument tracking system.

SCE urges the ARB to dedicate additional resources or hire contractors to run a minimum of *three* fully integrated practice auctions over the next three months in order to fully develop and test its systems and processes, and to repair any weaknesses that are discovered.[4] Potentially billions of dollars are at stake in the first auction; it is essential that ARB increase cap-and-trade

[4] The ARB could, for example, temporarily increase the AB 32 Administrative Fee by a fraction of a cent per metric ton to cover these costs.

implementation staffing to ensure that all systems and processes are fully tested and functional. Inadequate testing of these new processes and systems could be disastrous and the possible consequences far outweigh any potential short-term savings. Additionally, SCE respectfully requests a more detailed schedule outlining the necessary implementation and testing activities to ensure that compliance entities have enough detail to properly plan key readiness activities heading into November.

SCE has been closely involved in a cap-and-trade implementation working group with other market participants and has previously offered assistance (in conjunction with other electric utilities) to the ARB in developing milestones and a roadmap for implementing the cap-and-trade program. These activities include, but are not limited to:

- Designing, deploying, and testing a compliance instrument tracking system;
- Allocating time for program participants – compliance entities and regulators alike – to familiarize themselves with the ARB's systems, operations and processes, as well as to build their own systems and interfaces to the ARB's system;
- Designing, deploying, and testing an auction platform with market participants;
- Undertaking market simulation efforts to expose, and address market flaws that open the program to manipulation or gaming; and
- Opening an organized, ongoing forum to field stakeholder questions and concerns about ARB's implementation efforts, and incorporating stakeholder feedback.

SCE strongly encourages ARB to focus additional resources on these critical market readiness tasks. In a few short months, billions of dollars will flow through the auction and tracking systems, making it far too risky to rely on a less than comprehensive implementation process. It will do no good to attempt linkage to Québec, or to any other jurisdiction, if California's program is not successful. Multiple practice auctions with full integration of the ARB systems, processes, and controls are necessary for a successful initial auction on November 14, 2012.

IV.

SHOULD THE ARB CONTINUE WITH LINKAGE, IT MUST CONSIDER THE MARKET, REGULATORY, AND BROAD ECONOMIC IMPLICATIONS

SCE identifies below a number of problems arising from linkage to Québec and recommends that the ARB adopt the version of the Proposed Regulation Order that does not include linkage.

A. The ARB Must Consider and Develop Regulation Language to Address Issues Associated with De-linking

SCE previously 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.[5] For example, SCE asked how a covered entity would manage its allowance holdings from a linked jurisdiction in the case of de-linking. For example, in order to incorporate the risk of linkage failure (and consequently losing allowance value), market participants in California might trade allowances from Québec at a discount to California allowances. In that case, the two systems would never truly be linked and the allowances would not be truly fungible. In the ISOR, the ARB staff briefly addressed this issue and noted that regulatory action would be needed for de-linking.[6] ARB staff also correctly noted that although staff "cannot pre-suppose Board action," they "expect that previously-issued Québec compliance instruments would continue to be eligible for use in the California program."[7] While this statement is encouraging, it will not provide sufficient certainty to market participants. Further, in such a situation, the California GHG compliance market would be oversupplied and the State would not achieve the reductions envisioned under the cap-and-trade program. Instead, well-developed rulemaking language must be included in the regulation in order to reduce the

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5 SCE April Comments, at 2.
6 ISOR at 19.
7 *Id.*

likelihood of market participants discounting the price of allowances to account for the risk of de-linking.

Similarly, Section 95920(d) adjusts holding limits to account for linkage with Québec. If linkage does occur, SCE supports this modification to allow covered entities necessary flexibility. It is unclear, however, what would happen to entities whose holdings reach the new holding limit if California and Québec were to de-link. Would these entities be forced to divest the allowances that exceed the previous California-only holding limits?

SCE recommends that the ARB consider these market implications and modify its regulation before linking to any outside program.

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

The ARB must consider how international linkage may affect the appropriate regulator for the allowance trading market. Because the ARB is conducting an auction with international and interstate participants, it may need to consider the intrusion upon, and potential dilution of, its regulatory authority over the primary market auction. If allowances and offsets are eventually considered commodities by federal regulators, then many (or in some cases, all) GHG 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*.[8] If some compliance instrument-related products are deemed securities, the ARB could be exempt from the issuer requirements of federal and state securities laws. However, because it will be offering allowances issued by Québec in its auction, it could be considered a broker-dealer with respect to those allowances and could be

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[8] *See, e.g.*, 7 U.S.C. § 2 (1)(a) (broadly defining the jurisdiction of the CEA and CFTC for transactions in interstate commerce). The CFTC is currently promulgating a wide-variety of rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act, some of which may implicate California's GHG emission allowances.

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.[9]

C. The ARB Must Establish Objective Criteria Before Linking With Other Jurisdictions

SCE has consistently supported a national cap-and-trade program, or in the alternative, a broad cap-and-trade program with linkage to other jurisdictions. A broader program will create more efficient markets that will benefit all Californians that bear the impact of a carbon price on their consumer products. The Western Climate Initiative ("WCI") recently released an economic analysis assessing a linked program between California and Québec.[10] While SCE continues to support a wide-ranging, robustly-designed cap-and-trade market, this report raises concerns that linkage with Québec may fail to create such a market. Indeed, the relative size of Québec to California is a red flag that leads SCE to question whether this partnership could truly achieve the primary goal of linkage - a wide-ranging market that will result in lower compliance costs due to more efficient distribution of emissions reductions.

Because Québec alone does not offer California the opportunity to develop a comprehensive and robust cap-and-trade market, the ARB must consider including other jurisdictions in a linked trading environment. Other WCI jurisdictions no longer have public support for linked cap-and-trade programs. Unfortunately, a California-Québec system is insufficient to provide the necessary benefits for efficient emissions reductions. The ARB should not enter into a linking agreement with Québec until linkage with other jurisdictions is a realistic

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[9] *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. §1 *et seq*.) or of a CFTC rule."). In addition, due to a linkage with Québec, the entire program may face problems under the Dormant Foreign Affairs Power doctrine.

[10] Western Climate Initiative, Discussion Draft Economic Analysis Supporting the Cap-and-Trade Program-California and Quebec, Prepared by the WCI Economic Modeling Team, May 7, 2010, at 7, available at http://www.westernclimateinitiative.org/document-archives/Economic-Modeling-Team-Documents/Discussion-Draft-Economic-Analysis-Supporting-CA-and-QC-Linking/.

option. SCE recommends that ARB develop of a set of criteria to assess this and future linkages to ensure that the overall policy, economic, and environmental impacts of such partnerships are in line with California's cap-and-trade goals.

V.

SCE CONTINUES TO HAVE SIGNIFICANT CONCERNS REGARDING THE TREATMENT OF ELECTRICITY IMPORTS

A. Failing to Address Out-of-State Electricity Imports Could Have a Large Distortionary Impact on the California Independent Systems Operator ("CAISO") Electricity Markets

In the cap-and-trade regulation, "imported electricity" includes "electricity delivered across balancing authority areas from a first point of receipt located outside the state of California, to the first point of delivery located inside the state of California, having a final point of delivery in California."[11] SCE and several other parties have raised the issue of the compliance responsibility of out-of-state sellers bidding into CAISO markets at nodes that are physically located outside of California.[12] The ARB has indicated that it believes that such sales at out-of-state interties constitute deliveries of this electricity into California, and thus these sellers will be considered "First Deliverers" and required to comply with the California cap-and-trade regulations.

The ARB must be aware that it may not be able to fully enforce this definition and the corresponding compliance framework, which in turn could have a large distortionary impact on the GHG allowance market and the electricity markets. Out-of-state electricity sellers may choose not to inform the ARB of their electricity sales into the CAISO markets at out-of-state interties. Such sellers may argue that such sales took place outside of California and therefore are not under

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[11] Final Regulation Order (December 2011), at 20. http://www.arb.ca.gov/regact/2010/capandtrade10/finalrevfro.pdf.

[12] Comments of Southern California Edison Company to the California Air Resources Board on the Public Meeting to Discuss Compliance Requirements for First Deliverers of Electricity, Held May 4, 2012, at 8-9.

the ARB's jurisdiction, or that the electricity was simply sold into a large pool without any predetermined California sink. They could claim that it is CAISO that brings the power into the state, and that therefore CAISO is the true importer of their electricity. Below, SCE discusses two major problems that will result and suggests immediate action that the ARB must take to address these issues.

1. The CAISO Market Will Experience Significant Distortionary Effects

If out-of-state sellers believe that they will not eventually have to bear the compliance burden for their sales and deliveries at out-of-state CAISO delivery points, they will not include GHG costs in their bids and can place much more competitive bids than in-state generation. Such actions will thwart the cap-and-trade program's goal of including an accurate GHG price signal in wholesale electricity prices. Moreover, the California electricity markets will suffer immediate and harmful effects as *seemingly* lower-cost imports (possibly from higher GHG-emitting sources) outcompete California-based generation. The resulting electricity dispatches, based on false economics, will likely cause numerous problems including the increased use of CAISO reliability backstop measures, the costs of which entities such as SCE or other stakeholders must unfairly bear. Additionally, this may reduce the dispatch of California's highly flexible generation resources, exacerbating the State's challenge to integrate renewable resources into the electricity grid.

2. The ARB May Have Difficulty Assigning an Emissions Obligation for a Large Portion of California's Imported Electricity

SCE does not suggest that potential claims by out-of-state sellers that they are not "first deliverers" are correct. But lengthy regulatory or legal action may be needed to settle these disputes, which will create tremendous uncertainty and volatility in the allowance and electricity markets. Furthermore, should these arguments prevail, the ARB will be left with a large number of import-related emissions for which no entity will take responsibility. SCE maintains that any attempt to require downstream California electrical load customers to backstop this obligation will

violate the nature of a source-based cap-and-trade program and be unjust and unreasonable. Such a structure would force downstream electricity users to pay for GHG compliance twice: once in the form of higher wholesale electricity clearing prices, and again through an after-the-fact downstream cascade of compliance obligation. Meanwhile, out-of-state sellers would reap a windfall and cause lasting damage to the efficient functioning of the electricity markets in California.

3. The ARB Must Develop a Data Collection Process with Specific Provisions for Enforcement Against Out-of-State Sellers

It is imperative that these import concerns be addressed before the cap-and-trade market officially begins. SCE emphasizes that the CAISO market impacts will likely occur simply with the *speculation* that there is a loophole in the ARB's regulation, even if any official challenge is eventually defeated. This speculation already exists. To address this potential issue and to reduce speculation, SCE proposes that ARB undertake the following actions:

- Initiate a process to collect the data needed to identify all imported electricity transactions within a compliance year: The data should include (1) all North American Electricity Reliability Council ("NERC") E-tags created when electricity is scheduled to flow into any of the California balancing authorities, and (2) all information about all dynamically scheduled electricity and electricity scheduled over pseudo-ties connected to the California grid.[13] The ARB should compare the collected data with the compliance entities' reports and verify that all electricity reflected on the NERC E-tags is accounted for. SCE strongly recommends that the ARB immediately adopt this process and perform this exercise for 2011 data to demonstrate good faith and to proactively identify existing reporting issues. The results should be discussed at a later public meeting dedicated to this topic.

- Develop specific provisions for enforcement procedures against out-of-state sellers: SCE urges the ARB to outline its regulatory and statutory authority to enforce compliance within the mandatory reporting requirements and the cap-and-trade regulations, as well as the steps it will take to initiate enforcement actions and the potential consequences of such enforcement action. SCE suggests partnering with the CAISO in developing these regulations, in consultation with the State Attorney General.

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[13] Specifically, because the problem arises mostly due to interties in the CAISO system that are physically located outside of California, the ARB should collect all of the NERC E-tags that were created when electricity was scheduled to flow into the CAISO *system*.

B. Additional Electricity Import Issues Must Be Resolved

A number of important issues relating to electricity imports must still be addressed before the system and the market "go live." These include the definition of resource shuffling, the calculation of the QE Adjustment, and language relating to the RPS. The current regulation (and in the Proposed Regulation Order for Linkage) continues to be vague and open to interpretation.[14] Below, SCE briefly describes its suggestions for the record.

SCE recommends that the ARB:

- Modify the definition of resource shuffling and also provide specific examples of resource shuffling in order to guide the behavior of electricity market participants. The definition of "resource shuffling"[15] is so vague that it could chill typical market behavior. The ARB should identify specific situations or provide specific exemptions for typical electricity market behaviors. SCE also proposes that the ARB redefine resource shuffling as "any intentional plan, scheme, or artifice to avoid importing higher emissions resources by engaging in an improper substitution of such higher emissions resources with lower emissions resources. Such substitution would not be considered resource shuffling if the lower-emitting resources are eligible to be counted towards RPS compliance in California or if the lower-emitting resources are surplus resources at the time of import in the area from which the imported electricity is sourced, even if these resources are typically committed to serve load outside of California."

- Improve the QE Adjustment to remove perverse incentives that could discourage imports of low-carbon electricity. SCE continues to advocate for some minor modifications to address some of the perverse incentives created in the current regulation language that could discourage low-carbon energy imports. SCE recommends that the ARB consider adopting its "lowest first" QE Adjustment Calculation or its "lowest non-zero" redline change to improve the cap-and-trade regulation language and remove this disincentive to bring low-carbon energy into California.

- Modify the language relating to Renewable Energy Credits ("RECs") in the cap-and-trade regulation and the Mandatory Reporting Regulation ("MRR") to ensure consistency with California's RPS. SCE supports the ARB's efforts to sure that out-of-state renewable electricity from an eligible renewable energy resource (that compliance entities can count towards California's RPS program) should receive proper GHG treatment under the ARB's cap-and-trade program. SCE suggests that the regulations be modified to prevent double-counting of renewable energy attributes while recognizing the requirements and

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[14] For a detailed discussion of these concerns, see generally SCE May 4 Imports Comments.

[15] California Air Resources Board, Cap-and-Trade Final Regulation Order ("Final Regulation Order"), October 2011, § 95802(a)(251), at A-40.

functioning of California's RPS program, and looks forward to working closely with the ARB to develop this language.

VI.

THE AMENDED AUCTION PROVISIONS SHOULD BE CLARIFIED TO ENSURE A SMOOTH AUCTION PROCESS

A. Regulated Entities Should Be Able to Share Confidential Bid Data with Their Regulators

Section 95914(c)(1) of the Proposed Regulation Order for Linkage would prohibit the disclosure of bidding information "among auction participants."[16] Although the title of the subsection implies that this non-disclosure rule applies only "among" auction participants, the language itself could be construed as restricting the flow of information to regulators. Consequently, the regulation language must be clarified for highly-regulated entities. The proposed language prohibits the release of auction participation information, "unless it is to an auction advisor or other members of a direct corporate association" not subject to auction participation restrictions or cancellations.[17] The ARB should plainly state that this language does not prohibit regulated entities such as SCE from sharing bidding information as required through regulatory or legal directives.

For example, as SCE seeks procurement authorization and demonstrates compliance with California Public Utilities Commission ("CPUC")-approved procurement plans, SCE will need to regularly share its bidding strategies, bid prices, and other confidential bid information with the CPUC staff. SCE is also required to periodically discuss its bid prices and bid strategies with its Procurement Review Group, a CPUC-formed advisory group of non-market participant parties that reviews the details of SCE's overall procurement strategy, including Requests for Offers, portfolio positions, procurement transactions, and other procurement processes.[18]

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16 Proposed Regulation Order for Linkage § 95914(c)(1), at 60.
17 *Id.*
18 See Decision ("D.") 07-12-052, at 119.

B. The Consignment Requirement for the November 2012 Auction Should Be Adjusted from One-Third to One-Fifth of the Allocated 2013 Allowances

SCE commends the ARB's decision to revise the auction schedule to allow ARB staff and other stakeholders to "perform a number of important activities before [the first real auction], including efforts to maximize stakeholder readiness."[19] However, the new allowance consignment requirements for the sole 2012 auction (currently scheduled for November 14, 2012) could damage the market and consequently should be revised.

Section 95892(c)(1) of the Proposed Regulation Order for Linkage would require that each investor-owned utility ("IOU") consign one-third of its 2013 allowances to the November 2012 auction.[20] 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.

C. The ARB Should Inform Market Participants When It Withdraws Allowances for Consignment to the Next Auction

Under Section 95910(d)(2) of the Proposed Regulation Order for Linkage, allowances withdrawn from closed accounts, accounts exceeding the holding limit, or accounts suspended or revoked would be consigned to the next auction.[21] At any bidders' conference preceding an auction where the ARB intends to offer such allowances, the ARB should notify market participants of the volume of withdrawn allowances that will be made available for purchase. Such an announcement will allow for greater transparency for auction participants.

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19 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.

20 Proposed Regulation Order for Linkage § 95892(c)(1) at 33. The ARB combined the allocation from the November auction with the allocation from the now-cancelled August 2012 auction. In addition, 10 percent of all 2015 allowances will be auctioned in the Advance Auction, increasing the total number of allowances available at the November 14th auction by roughly 40 million.

21 Proposed Regulation Order for Linkage § 95910(d)(2), at 36.

D. The ARB Should Carefully Consider the Effect on the Developing Allowance Market of the Revised Auction Format Provisions in Sections 95911 and 95912

In Sections 95911 and 95912 of the new Proposed Regulation Order for Linkage, the ARB has substantially revised the format for the auction of California allowances. Below, SCE provides its comments on the amended language.

1. Section 95911(c)(3): To Avoid Penalizing Compliance Entities in Jurisdictions with Weaker Currencies, the ARB Should Set the Auction Reserve Price in One Currency Only

Section 95911(c) of the Proposed Regulation Order for Linkage contains new language setting the Auction Reserve Price and accounting for linked jurisdictions. Section 95911(c)(3), which links the price floors of the two jurisdictions, could dramatically affect floor prices and consequently the allowance market. The revised Section 95911(c)(3) provides:

> (A) The Auction Reserve Price in U.S. dollars shall be the U.S. dollar Auction Reserve Price for the **previous calendar year** increased annually by 5 percent plus the rate of inflation as measured by the most recently available twelve months of the Consumer Price Index for All Urban Consumers.
> (B) […]
> (C) The auction administrator shall set the exchange rate as the most recently available noon daily buying rate for U.S. and Canadian Dollars as published by the Bank of Canada, and shall announce the exchange rate prior to the opening of the auction window.
> (D) The Auction Reserve Price in Canadian dollars shall be the Canadian Dollar Auction Reserve Price for the **previous calendar year** increased annually by 5 percent [. . .]
> (E) The auction administrator will use the announced exchange rate to convert to a common currency the Auction Reserve Price previously calculated separately in U.S. and Canadian dollars. The auction administrator will set the Auction Reserve Price **equal to the higher of the two values**.[22]

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[22] Proposed Regulation Order for Linkage § 95911(c)(3)(A)-(E) (emphasis supplied), at 39-40.

This method could penalize unnecessarily the jurisdiction with the weaker currency. For example, if one of the two currencies were to continually weaken, the weaker currency's price floor in the native denomination will be much higher than it would have been. Such weakening is not theoretical; the U.S. dollar has systematically weakened compared to the Canadian dollar over the past ten years. If such a trend continues, the compliance entities in the jurisdiction with the weaker currency would face much higher compliance costs simply because they would be subjected to a much higher floor price.

Moreover, the price floor could increase significantly with linked price floors than in a California-only market. The ARB is relying on the concept of purchasing power parity, a theoretical relationship between inflation rates and currency exchange rates, with no guarantee that such a relationship would hold in practice. Even a 10% variance in allowance prices away from the price floor (without adjustments for the currency exchange) could result in a sizeable increase in compliance costs. If a theoretical relationship between inflation and exchange rates were to hold, there would be no need to mandate currency update in the regulation.

SCE suggests that the ARB modify Section 95911(c)(3)(E) to set the Auction Reserve Price in one currency only, and adjust the floor price by 5% plus inflation when applying it to the joint auction. When one currency appreciates more than a second, the first currency will have more purchasing power, with or without price floors. As with other commodities, the ARB should allow each buyer and seller to assume foreign currency risk. SCE opposes linking price floors, which would create, rather than prevent, market distortions.

2. Section 95911(e): Settling Tie Bids in a Proportional Manner is Efficient and Fair

Section 95911(e)(5) contains updates to the bid settlement language that would allow tie bids to be settled in a proportional manner.[23] Previously, the regulation resolved tie bids by

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[23] Proposed Regulation Order for Linkage § 95911(e), at 41.

assigning random numbers to bundles of allowances at each bid price. SCE supports the proposed approach as efficient and fair.

3. Section 95912(i)(2): The ARB Should Clarify the Language Describing the Amount of the Bid Guarantee

Section 95912(i)(2) of the Proposed Regulation Order for Linkage describes the minimum amount for each auction participant's bid guarantee.[24] While the language in this section was fairly straightforward in the Final Regulation Order, the revised language in the Proposed Regulation Order for Linkage is overly complex and confusing. SCE recommends rejecting these proposed modifications and preserving the language of the Final Regulation Order stating that "the amount of the bid guarantee must be greater than or equal to the sum of the value of the bids submitted by the auction participant."[25]

VII.

SCE PROVIDES RECOMMENDATIONS TO IMPROVE THE REGULATION PROVISIONS ADDRESSING REGISTRATION AND ACCOUNTS

A. The Revised Registration and Know-Your-Customer Requirements Pose Serious Logistical, Privacy, and Confidentiality Challenges

Section 95830 of the Proposed Regulation Order for Linkage revises some of the registration requirements, introducing additional information about an entity's officers and requiring compliance with the "Know-Your-Customer" requirements outlined in Section 95834.[26] SCE supports the ARB's desire to improve the security and integrity of the tracking system, but cautions again[27] that the new provisions may raise logistical difficulties as well as privacy

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[24] Proposed Regulation Order for Linkage § 95912(i)(2), at 49.
[25] Final Regulation Order § 95912(i)(2), at 134.
[26] Proposed Regulation Order for Linkage § 95830, at 8-9.
[27] Comments of Southern California Edison Company to the California Air Resources Board on the Public Meeting to Discuss Compliance Requirements for First Deliverers of Electricity, Held May 4, 2012, at 9.

concerns. For example, Section 95830(c) requires a covered entity to provide the names and addresses of the entity's directors and officers without specifying 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 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 does not support requiring compliance entities to provide the names and addresses of all of their directors and officers. This language should be removed. Alternatively, SCE recommends (1) removing the requirement of providing addresses, and (2) clarifying that entities provide this information one time only, at the start of the compliance obligation that commences January 1, 2013. Moreover, the ARB should provide a clear definition of "directors and officers" to avoid confusion from out-of-state entities.[28]

In addition, Section 95834(b) requires any individual that is given access to the tracking system to comply with the proposed "Know-Your-Customer" provisions.[29] Such individuals must provide, among other things, the address of his or her permanent residence, birth date, passport numbers, driver license numbers, and bank account numbers, all certified by a notary public. Again, although accurate identification of participants in the tracking system is essential, requiring this level of personal information is too onerous and intrusive (especially for large, publicly-traded companies 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

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[28] The ARB could, for example, simply refer to a company's annual report, which is publicly available and where such names and titles are typically published.

[29] Proposed Regulation Order for Linkage §95834(b), at 27-28.

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 advises the ARB to revise this regulation language to remove the collection of this level of personally identifiable information.

Section 95830(g), entitled "Information Confidentiality," states that registration information will be treated as confidential by the Executive Officer and the accounts administrator.[30] This provision raises a number of important questions:

- How will ARB guarantee the confidentiality of the information?
- Why is confidential treatment restricted to just the "Executive Officer and the accounts administrator"? This confidentiality should apply to all individuals with access, including ARB employees, officers, contractors, and consultants.
- Why does ARB state it will only keep information confidential "to the extent possible"?
- Will ARB be audited for compliance with information confidentiality requirements (preferably by an outside agency)?
- What are the codes of conduct, processes, and protocols for ARB's compliance with the confidentiality requirements?
- How will ARB monitor its own systems and processes to ensure confidentiality? How will violations be identified?
- If confidentiality is violated, what recourse is available? Will there be penalties, fines, other punitive actions, or subsequent corrective actions implemented?

Protecting the confidentiality of this information is a significant endeavor. The ARB has a duty to the compliance entities to ensure that the confidentiality process is robust and clearly explained.

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[30] Proposed Regulation Order for Linkage § 95830(g), at 11.

B. The ARB Should Clarify the Designations of Authorized Account Representatives

Section 95832 of the Proposed Regulation Order for Linkage provides that each regulated entity will have a single primary account representative and no more than four alternate account representatives.[31] SCE appreciates the increase in the number of account representatives, but suggests that the total number of alternate account representatives be increased to five in order to allow for internal redundancy and control checks throughout the transfer process.

SCE also requests the following clarifications to certain portions of this section.

- "Agreement": Sections 95832(a)(3) and 95832(c)(2) reference an "agreement" in the context of selecting account representatives.[32] It is unclear what this "agreement that is binding" represents, and what the criteria for terms and conditions of such agreements are. Unless it is an ARB-provided pro forma agreement, concerns could arise regarding consistency among all the covered entities, and potential exposure for other entities.

- "Ownership Interest": Sections 95832(a)(2) and 95832(a)(3) reference "ownership interest with respect to compliance instruments."[33] How is this concept defined? For a large company, it not certain who "all persons who have an ownership interest" would be. SCE requests clarification on this point.

- Attestation: In order to further refine Section 95832(d), SCE suggests the following modifications:

  > ". . . I certify under penalty of perjury under the laws of the State of California that to the best of my knowledge and/or as represented to me by those individuals the statements and information submitted to ARB. . .;"

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31 Proposed Regulation Order for Linkage § 95832, at 14-21.

32 Section 95832(a)(3) states "I certify under penalty of perjury under the laws of the State of California that I was selected as the primary account representative or the alternate account representative, as applicable, by an **agreement** that is binding on all persons who have an ownership interest with respect to compliance instruments held in the account." Proposed Regulation Order for Linkage § 95832(a)(3), at 15 (emphasis supplied). Section 95832(c)(2) states "The primary account representative and any alternate account representative for the account shall represent and, by his or her representations, actions, inactions, or submissions, legally bind each entity that owns compliance instruments held in the account in all matters pertaining to this article, notwithstanding any **agreement** between the primary account representative or any alternate account representative and such entity." Proposed Regulation Order for Linkage § 95832(c)(2), at 16 (emphasis supplied).

33 Section 95832(a)(2) states "Name of the organization designating the primary account representative or any alternate account representative to represent its **ownership interest** with respect to the compliance instruments held in the account." Proposed Regulation Order for Linkage § 95832(a)(2), at 15 (emphasis supplied). Section 95832(a)(3) states "I certify under penalty of perjury under the laws of the State of California that I was selected as the primary account representative or the alternate account representative, as applicable, by an agreement that is binding on all persons who have an **ownership interest** with respect to compliance instruments held in the account." Proposed Regulation Order for Linkage § 95832(a)(3), at 15 (emphasis supplied).

". . . I am aware that there are significant penalties for knowingly and/or intentionally submitting false statements and information."

These modifications are consistent with the intent of Section 95832(d) to ensure that the entity filing the report takes responsibility for the attestation. Currently, the proposed language transfers the obligation for attesting to personal knowledge of each data element onto the individual signing the attestation. It is unreasonable to place criminal sanctions upon one individual for a failing elsewhere in the filing entity's organization, given the size of their organizations, the volume of data to be reported, and the varied roles of those compiling the reports. SCE's proposed adjustments will still serve the ARB's purpose of ensuring that each compliance entity has an individual responsible for ensuring the correctness of each report, but without placing an outsized burden of guaranteeing each item of data under threat of criminal sanctions.

VIII.

PROVISIONS GOVERNING THE CONDUCT OF TRADE SHOULD BE IMPROVED

Section 95921 of the Proposed Regulation Order for Linkage provides revised rules for the "Conduct of Trade," including substantial modifications to the procedure for transfer requests.[34] SCE provides comments on some of the subsections below.

A. Section 95921(a)(1): The Timing for the "Push-Push-Pull" System Must Be Clarified to Refer to Business Days and Allow Two Business Days for the "Pull"

Section 95921(a)(1) would establish what the ARB has termed the "push-push-pull" system, where an account representative from the source account of the transfer submits a transfer request (push) that must be separately confirmed by a second account representative for that same entity (push), after which an account representative for the destination account must confirm the transfer request (pull).[35] The current regulation language requires the transfer to be completed within three days, providing two days for the second push and one day for the pull.[36] SCE suggests that the ARB require the second push to occur within one business day of the transfer

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[34] Proposed Regulation Order for Linkage § 95921, at 69-75.
[35] Proposed Regulation Order for Linkage § 95921(a)(1)(A)-(E), at 69-70.
[36] *Id.*

request (by close of business local time, 5 p.m. PPT) and that the pull be completed within three business days of the transfer request (by close of business local time, 5 p.m. PPT).[37]

SCE strongly urges the ARB to amend the mandated timelines for compliance instrument transfer requests to refer to "business days" to avoid confusion with calendar days. This modification would better reflect the practices in banking or commodity trading to publish market holidays and close on those market holidays or weekends. In addition, while payment and allowance transfer may not be linked, if payment is required for the allowance transfer, many compliance entities may be able to make payments only on business days. Without this clarification, the ARB could limit the flexibility of transactions and cause unusual transaction behavior. For example, buyers of compliance instruments may be reluctant to enter into spot transactions on Fridays if the transfer would require a confirmation during the weekend. To ensure clarity and certainty in the market, the ARB should provide a clear definition of "business day" and specify the holidays it (and any linked jurisdiction) plans to observe.

B. Section 95921(b)(2): Direct Transfers of Compliance Instruments to Another Entity's Compliance Account Should Be Permitted

Currently, compliance instruments cannot be transferred directly into another entity's compliance account but instead must go through that entity's holding account. SCE proposes allowing transfers directly into a compliance account, as this will provide compliance entities more flexibility in terms of account management and fits well with the push-push-pull mechanics described above. The ARB should revise the text in Section 95921(b)(2) of the Proposed Regulation Order as follows: "Holding account number or compliance account number of destination account and identification of primary account representative or alternate account representative for the destination account confirming the transfer request."[38]

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[37] For example, when a transfer request is initiated on a Monday, the second push would occur by 5 p.m. PPT on Tuesday, while the pull would be completed by 5 p.m. PPT on Thursday.

[38] Proposed Regulation Order for Linkage § 95921(b)(2), at 71.

C. Section 95921(b)(6): The ARB Should Adjust Its Price Reporting Requirements to Ensure that It Gathers Meaningful Data

SCE supports the ARB's efforts to monitor the GHG compliance instrument market to prevent market manipulation. Section 95921(b)(6) of the Proposed Regulation Order for Linkage would require parties to report the price of the compliance instrument to the accounts administrator as part of a transfer request.[39] However, the proposed language would not require parties to indicate the contractual structure of the underlying transactions. Failing to distinguish between different categories of transactions may lead to inconclusive data, or data that is impossible to use for monitoring purposes. Transactions such as physical settlements of tolling agreements, call and put options, and in-kind settlement agreements do not have a dollar figure for what is typically considered to be a "price." Physical settlements of tolling agreements would have a zero "price" because a utility is obligated to procure allowances, while in-kind settlement agreements would not settle in dollar terms and also cannot have a "price." These transaction types would skew analytical results if aggregated with price data from other types of transactions.[40] Still, the current rules for price reporting could be effective in monitoring the prices of simple spot, forward, and futures contracts.

To remedy these potential inconsistencies in reported transaction prices, transferors should designate the structure of each reported transaction as a spot transaction, forward transaction, futures transaction, or a transaction without an accurate price to report. The first three categories would provide price data that is useful to the ARB. Allowing entities to provide a "not applicable" answer for the fourth category would prevent a skewed data set. For the "not

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[39] Proposed Regulation Order for Linkage § 95921(b)(6), at 71.

[40] For example, a tolling agreement may specify that an entity will cover the tolling counterparty's GHG compliance obligation, and it might do so by physically transferring compliance instruments. There is no monetary exchange for these compliance instruments; the price of compliance is built into the larger contract and thus cannot be clearly isolated. Similarly, for in-kind settlements there could be non-monetary payment for compliance instruments. For example, an entity could pay a farmer an up-front sum to build an anaerobic digester in return for offset credits. Lastly, call (and put) options involve an up-front payment for the right to purchase (or sell) compliance instruments at a pre-established "strike price." The strike price is arbitrary and, therefore, not appropriate or useful to report and monitor.

applicable" transactions, ARB or the monitoring agency could periodically request additional documentation to prevent abuse.

D. Section 95921(e): The ARB's Regulations Should Signal the Intent and Principles for Market Performance and Market Data Publication to Design Data Publication Rules Outside of the Regulation

Section 95921(e) addresses the protection and release of confidential information.[41] Given the potential consequences to the allowance market and electricity markets if confidential information is mishandled, SCE strongly supports the protection of confidential information by the Executive Officer and accounts administrator. Still, publishing some public data is necessary to augment external monitoring efforts and to discourage market participants from manipulative positions. The ARB should revise its regulation to indicate its intent to publicly release appropriate transaction data and outline the intent, goals, and principles for data publication. Along with the ARB's market monitor and stakeholders, the ARB can create business process documents outside of the regulation to establish the exact processes for data publication.

SCE recommends that the ARB hold a workshop to solicit input on data publication structures and consult its Independent Market Monitor and Market Surveillance Committee on the issue. SCE cautions the ARB, however, that releasing all transaction data would expose parties' cap-and-trade procurement or strategies and positions, for which confidentiality can be crucial. To this end, SCE suggests that the ARB delete Section 95921(e)(4), which would expose compliance entities' compliance account holdings. SCE also recommends that the ARB exercise sensitivity with respect to releasing transfer price and quantity data under Section 95921(e)(1). Ensuring an appropriate level of transparency is of the utmost importance and should be discussed thoroughly with stakeholders as the ARB and its market monitor develop data publication protocols outside of the regulation.

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[41] Proposed Regulation Order for Linkage § 95921(e), at 73.

E. Section 95921(f)(1): With the Removal of Beneficial Holding Relationships, the Language Must Be Amended to Allow Electrical Distribution Utilities to Satisfy Their Contractual Obligations

With the removal of the beneficial holdings construct, Section 95921(f)(1) is now unclear as to how an entity may acquire allowances and hold or possibly transfer them to another entity.[42] SCE agrees that the beneficial holdings regulation language was challenging and confusing and does not object to its deletion. But the problem that the beneficial holdings language was designed to address remains.

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. As SCE has previously explained,[43] IOUs such as SCE purchase a large portion of their customers' energy requirements through bilateral contracts with independent power producers ("IPPs") 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 limited exemption to the holding limit. SCE requests that the ARB clarify this language in order to enable IOUs to satisfy their contractual obligations and procure compliance instruments for eventual transfer to a contractual counterparty that would not challenge the IOUs' holding limits.

SCE is eager to work with ARB staff to either develop a replacement for the beneficial holdings construct or revise the holding limits. The ARB should clarify that holding compliance instruments "on behalf of" other entities applies solely to arrangements where the counterparty has a legal interest in the compliance instruments in question. ARB staff has suggested that it will collect ideas and market simulation data in the summer months before the first auction and

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[42] Proposed Regulation Order for Linkage § 95921(f)(1)-(2), at 73.
[43] SCE December 2010 Comments, at 14-15.

develop a concept paper with proposals. SCE supports this plan and offers its assistance so that a measured and careful approach can be considered and introduced in the next round of regulation amendments.

IX.

CONCLUSION

SCE thanks the ARB staff for their hard work in developing amendments to the cap-and-trade regulation contained in the Proposed Regulation Order, and the Company appreciates the opportunity to comment on the proposed amendments. SCE urges the ARB to consider these comments and recommendations for improving the regulation.

SCE looks forward to continuing to work closely with staff to develop program rules and further revise the cap-and-trade regulation in order to achieve a successful cap-and-trade program.

Respectfully submitted,

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