

STATE CAPITOL  
P.O. BOX 942849  
SACRAMENTO, CA 94249-0073  
(916) 319-2073  
FAX (916) 319-2173

WEBSITE  
WWW.ASSEMBLY.CA.GOV/HARKEY

# Assembly California Legislature



**DIANE L. HARKEY**  
ASSEMBLYWOMAN, SEVENTY-THIRD DISTRICT

COMMITTEES  
VICE CHAIR: APPROPRIATIONS  
BANKING AND FINANCE  
BUDGET  
PUBLIC EMPLOYEES, RETIREMENT  
AND SOCIAL SECURITY  
REVENUE AND TAXATION

---

## MEMORANDUM

---

**TO:** CHAIR PERSON NICHOLS & MEMBERS OF THE CALIFORNIA AIR RESOURCES BOARD  
**FROM:** ASSEMBLYWOMAN DIANE HARKEY  
**SUBJECT:** CALIFORNIA AIR RESOURCES BOARD TESTIMONY REGARDING PUBLIC CONSULTATION OF INVESTMENT OF CAP-AND-TRADE AUCTION PROCEEDS  
**DATE:** MAY 24, 2012  
**ATTACHMENTS:** LETTER FROM LEGISLATIVE ANALYSIS OFFICE DATED MAY 18, 2012 (11 PAGES)

---

Chairperson Mary Nichols and Board Members:

Thank you for allowing me to speak today. AB 32 is state law and as such I am not attempting to address the need for the regulation, nor debate whether implementation will be good or bad for business interests.

I am here to testify with regard to Cap and Trade and encourage a cautious and measured approach to achieving revenues, while simultaneously achieving the goals of AB 32. We've witnessed during the energy crisis, mortgage crisis, the JP Morgan debacle still unraveling, and the Facebook IPO, that markets are unpredictable and subject to gaming and manipulation, in a variety of unforeseen ways.

Since 2002, California has suffered billions of dollars in losses associated with financial crises. I do appreciate that CARB continues to attempt to eliminate potential market risk exposure. But I would argue that even the sophisticated Wall Street bankers, such as Goldman Sachs and JP Morgan, supposedly best and brightest in the industry, with their own portfolio get it wrong. California, using public rather than private funds, should not expect to escape unscathed.

I would be cautious in reliance on Dodd-Frank. As with most legislation, Dodd-Frank is political, crafted on known past risks, and it appears that derivatives may fall into the abyss of unknown and difficult to quantify or regulate.

Responsibility, accountability and transparency must be established before we commit California to an unknown market path from which there will be no turning back. We will not be able to simply unwrap the trades, nor the pricing or agreements CARB is contemplating with foreign nations. Our State's financial condition is abysmal, and deteriorating; we cannot afford to create unrealistic continuous revenue expectations nor gamble with public funds.

Last month, in an attempt to alleviate my concerns, I submitted questions to the LAO. I am furnishing the responses, dated May 18, 2012, as part of my testimony and for the record. It appears CARB has done an excellent job of attempting to prevent gaming and collusion for the initial auction with a sealed bid. However I question how the lowest bidder that receives the residual credits manages to keep the doors open. Or how do large electricity users such as water agencies, protect the rate payers and users?

As for the secondary market, who will be allowed to participate and be registered with CARB? How will CARB or the contractor ensure that speculators will not be participants?

As for the derivatives market, there are too many options to speculate as to what issues might arise. Derivative or hedge funds during the housing boom created issues with the state's and other pension funds. What losses the state might suffer directly or indirectly due to hedge derivatives are unknown. Market manipulation or misbehavior in the derivative market, over which CARB has no control, could cause allowance prices to be high, creating excess leakage.

CARB has chosen to contract with the newly formed WCI, Inc. to support California and others with implementation of the program. However, contracts with WCI, Inc. are only subject to Bagley Keene and Public Records act to the extent that contracts are with the State of California. Should WCI, Inc. enter into third party contract the State would have no oversight or audit authority. The State of California funds a large portion of WCI, Inc.'s budget, and should not be in the dark. We are the 800 pound gorilla in the partnership and must insist on control and oversight of all contracting.

The LAO suggested that California Independent System Operator (CAISO) be included in the market surveillance committee as well as perhaps a representative from the Legislature. I would also offer that a representative from the State Treasurer's office should be included. The office of the Treasurer, based on my experience in the Capitol, is the only office that has any comprehension of market risks and how we might alleviate same.

I understand that the State Treasurer's office has been consulted, but only with the potential for securitizing a revenue stream anticipated from Cap and Trade revenues. Borrowing against future speculative revenues might be possible for a price, but it is imprudent. I would hope the Brown Administration would not be using a speculative securitized vehicle to fill the state's budget hole nor fund a proposed funding a future rail project from such schemes.

I also have some specific questions with regard to CARB acting as a regulator and market participant by withholding allowances. If CARB's goal is revenue enhancement they may want prices to be high. But this appears to conflict with minimizing costs. On another front, if the proceeds are indeed securitized and the bonds must be re-paid with revenues, keeping the prices high might be very important.

In closing, since the Administration and CARB seem determined to pursue cap and trade I urge you not to overreach and proceed cautiously. The investment bankers have found gold in California's financial crisis to be sure. Let's ensure the public, CARB and the Administration do not end up with fool's gold.



May 18, 2012

Hon. Diane Harkey  
Assembly Member, 73<sup>rd</sup> District  
Room 6027, State Capitol  
Sacramento, California 95814

Dear Assembly Member Harkey:

In a recent letter to us, you requested that we provide information regarding the oversight of carbon markets that will be established under the cap-and-trade regulation recently adopted by the California Air Resources Board (ARB). Specifically, you asked that we respond to a series of questions, which we have restated below followed by our responses.

**Background.** The Global Warming Solutions Act of 2006 (Chapter 488, Statutes of 2006 [AB 32, Núñez/Pavley]), commonly referred to as AB 32, established the goal of reducing greenhouse gas (GHG) emissions statewide to 1990 levels by 2020. In order to help achieve this goal, ARB adopted a regulation to establish a cap-and-trade program that places a “cap” on aggregate GHG emissions from entities responsible for roughly 80 percent of the state’s total GHG emissions. While they are not assigned an individual reduction target, entities that emit at least 25,000 metric tons or more of carbon dioxide equivalent (CO<sub>2</sub>e) per year are subject to the cap-and-trade regulation and are therefore considered to be a “covered entity.” When the program is fully operational, approximately 350 of the state’s largest emitters of GHGs will be subject to the regulation, including oil producers, refiners, and electricity generators. Over time, the amount of aggregate annual emissions allowed from covered entities (the cap) will gradually decline from just over 400 million tons to 341 tons. As the cap declines, the number of allowances ARB makes available will similarly decline.

In order to comply with the regulation, a covered entity must obtain one allowance (or equivalent thereof) for every ton of emissions that it emits during a given compliance period. Thus, a covered entity will need to determine if it is more cost-effective to purchase allowances or to reduce its emissions (such as by making energy efficiency upgrades in its facility). The first opportunity to obtain allowances will either be through ARB’s free allocation or through ARB’s allowance auction. After the initial auction, covered entities will have the opportunity to “trade” (buy and sell) allowances in the open market. As allowances become more scarce over time, their price will likely increase, which would create a greater incentive for covered entities to look for more ways to reduce their emissions in order to avoid purchasing relatively more expensive allowances. As such, it is the declining cap discussed above that will reduce the state’s GHG emissions.

## Specific Responses to Your Questions

*1. Could California issue emissions allowances without auctioning them? For example, could all of the allowances be distributed without charge, instead of just some of them?*

Generally speaking, carbon allowances could be distributed in one of three ways: (1) they could be all given away for free, (2) they could all be auctioned, or (3) some portion could be freely allocated while the other portion is auctioned. All of these approaches will yield the same programmatic results in terms of GHG reductions. This is because it is the declining cap on emissions that will reduce the state's overall level of GHGs—not the manner in which allowances are introduced into the market.

As indicated above, ARB has chosen to do a combination of auction and free allocation of allowances. Initially, a majority of allowances will be allocated for free to some covered entities in order to reduce the competitive disadvantage to those entities that are subject to the cap-and-trade regulation. The intent is to reduce what is called economic leakage—the decision by firms to relocate outside of California as a result of a perceived competitive disadvantage. In order to determine which industries may be competitively disadvantaged as a result of the cap-and-trade program and therefore may be at risk of leakage, the ARB evaluated covered entities' degree of reliance on energy in the production or distribution of their products as well as their exposure to out-of-state competition. It then classified covered entities as either high, medium, or low risk of leakage. According to the ARB, the sectors that it determined are at high risk of competitive disadvantage include oil and gas extraction, cardboard manufacturing, and the manufacturing of certain chemicals such as fertilizers. Medium-risk sectors include food processing, sawmills, and petroleum product manufacturing. Low-risk sectors include pharmaceutical, medicine, and aircraft manufacturing. The provision of free allowances will continue longer, and at higher levels, for entities in sectors determined to be at higher risk. The allocation of free allowances is also based on an entity's prior output. Within those sectors that receive free allowances, the more of a product, such as cement, that an entity produces, the more allowances it will generally get for free.

As previously indicated, it is possible for ARB to instead give all of the allowances away for free and still achieve the goals of AB 32. Covered entities would in turn receive some portion of the allowances needed to meet their compliance obligation. While such an allocation scheme would reduce some of the compliance costs for individual covered entities, it would, however, not completely offset all such costs since it is unlikely—especially in the out-years—that covered entities would receive sufficient allowances to fully meet their compliance obligations. Thus, covered entities would still need to either (1) purchase allowances from an entity that has been able to reduce its emissions (meaning it has an excess number of allowances to sell) or (2) reduce their own emissions if it is less expensive than purchasing allowances from another entity.

In its report to ARB, the Economic and Allocation Advisory Committee (established by Governor Schwarzenegger to advise ARB on the cap-and-trade regulation) discussed some of the benefits of using an auction to introduce allowances into the market. Specifically, the committee stated that auctioning allowances provides a better signal of firms' true costs of abatement than does free allocation. This is because when allowances are introduced through a competitive

auction, the market price of allowances indicates the costs that firms bear, at the margin, to reduce emissions. As such, an auction can play a valuable role in identifying the market-clearing price. The report also notes that an auction can make the assignment of allowance value more transparent by avoiding the need to employ complicated formulas to determine allowance allocation.

***2. The ARB will be providing free allowances to covered entities considered to be at risk of leakage, with the number of free allowances declining over time but not reaching zero. Has any assessment been done of these covered entities ability to reduce their emissions without causing job losses and business closures, and at what cost?***

We are not aware of any assessment that specifically examines the ability of those covered entities that will receive free allowances to reduce their GHG emissions without causing job losses and business closures. We would note, however, that ARB has evaluated the ability of *all* covered entities to reduce their GHG emissions as part of its "Initial Statement of Reasons" for the cap-and-trade regulation. Because the cap-and-trade program does not specify where emission reductions will occur, the ARB did not analyze the impact of the regulation on individual covered entities. Rather it created a "compliance pathway assessment" to examine the potential technologies that certain sectors could adopt to reduce their on-site emissions. Based on this assessment, the ARB concluded that the cap-and-trade program would lead to increased investment in efficient buildings and technologies and advanced fuels. The ARB also estimated that these investments would reduce fuel use by 2 percent to 4 percent by 2020. However, it notes that implementation of the cap-and-trade program would shift investment and growth within the overall economy toward those sectors driven by the production of cleaner and more efficient technologies. In other words, ARB estimates that there will be job losses in certain sectors and job gains in other sectors. Overall, the ARB finds that there would be no significant adverse impacts on California business or consumers as a whole as a result of the cap-and-trade regulation.

We also note that other analyses have been done on the impact of the cap-and-trade regulation on specific sectors. The findings of such studies have generally been less optimistic than those of ARB. For example, a recent report by Moody's Investor Services found that California refiners would see an increase in operating costs resulting from compliance with the cap-and-trade regulation. The report states that refiners will have to contend with certain operating restrictions that competitors in other states will not have, especially as 2020 approaches. According to the report, this will raise the cost of refined products in California over time, which will ultimately negatively affect the demand for such products. The report also found that the cap-and-trade regulation could discourage refiners from making big strategic investments in California, and eventually could cause certain higher-cost refineries to close.

***3. Does the use of an auction to distribute allowances create a risk of a bidding war for them, increasing the ultimate cost to covered entities and California consumers?***

The ARB has designed the cap-and-trade program to include a sealed bid, uniform price auction. These are similar to the type of auctions used in the Regional Greenhouse Gas Initiative (RGGI) program and the European Union Emissions Trading System. (The RGGI is a market-based regulatory program whose goal is to reduce GHG emissions among the states of

Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New York, Rhode Island, and Vermont.) Under a sealed bid auction, prices that participants bid are not revealed to others. In contrast, a dynamic bid auction involves real-time interaction between an auctioneer and multiple bidders. Under a uniform price auction, each participant bids a price for the desired number of units it wants to purchase. Once all the bids have been submitted, the auctioneer will then look to the highest bid and note the number of allowances requested by that bidder. Knowing the total number of allowances available at this auction, the auctioneer will continue to look to the second highest bid, the third highest bid and onward until it comes to the point that the total number of available allowances for that auction have been bid for. The price associated with this last bid becomes the clearing price or the uniform price that all successful bidders pay for their allowances. Successful bidders are those that had bid at this clearing price or above. Thus, all successful bidders pay the same price for their allowances. Priority is given to the highest bidder first, giving them the number of units requested, then the second highest bidder and so forth until the supply of allowances is exhausted. The result is that those that bid a price above the unit-clearing price typically receive the total quantity of units sought while the last bidder at the unit-clearing price will only receive the residual balance of units available. Because the auction is sealed and all successful bidders pay the same price for allowances, this type of auction design generally would not be susceptible to a bidding war.

---

***4. Who will be monitoring the secondary market for allowances and offset credits, including derivatives of these instruments?***

As we discussed in our report, *Evaluating the Policy Trade-Offs in ARB's Cap-and-Trade Program* (February 2012), the introduction of emission allowances and offset credits that are designed to be tradable gives rise to what is known as a carbon market. The carbon market will consist of a number of distinct but interrelated markets. The ARB's allocation or auction of emission allowances, as well as the development and certification of offset credits, will take place in what is commonly referred to as the "primary market." There are also so-called "trading markets" where trading activity related to compliance instruments will take place. These include the "secondary market" (where compliance instruments are traded directly) and the "derivatives market" (which involves the trading of financial contracts, primarily for hedging and investment, the value of which depends on the market behavior of compliance instruments).

The ARB will be responsible for overseeing the secondary market and has set rules for who may participate in the secondary market. Specifically, the ARB intends to allow covered and non-covered entities to participate as long as those entities have registered with ARB. Only entities with a potential conflict of interest, such as "verifiers" (entities and individuals who are responsible for auditing and verifying emission reductions), would be prohibited from participating in the secondary market. In order to enhance its oversight capabilities, ARB has contracted with external experts to provide and operate an auction platform, perform financial services, and conduct market monitoring and analysis. The ARB is also establishing a "Market Surveillance Committee" comprised of experts who will review market conditions and advise ARB on the design and execution of its market oversight responsibilities.

According to ARB, it does not have the authority to govern participation in the derivatives market. This is because such authority is within the sole jurisdiction of the U.S. Commodity

Futures Trading Commission (CFTC). Thus, ARB is meeting periodically with CFTC to develop processes that would allow the two agencies to share information about activity in the derivatives market. Meanwhile, CFTC is in the process of developing new regulations to implement the federal Dodd-Frank Act, which, in part, is intended to deter potential market manipulation. Although the CFTC has exclusive responsibility for oversight of the derivatives market, states can bring suit on behalf of their residents to prevent violations of the Commodity Exchange Act (or its regulations), as well as to obtain damages as a result of violations. Consequently, a close working relationship with CFTC would enhance California's ability to seek remedies under this authority.

***5. Is the Western Climate Initiative, Inc. subject to the same statutory requirements as ARB such as the Bagley Keene Act, the Public Records Act, the Political Reform Act, the Public Contract Code and other basic California laws that provide transparency and accountability for state government?***

Western Climate Initiative, Inc. (WCI, Inc.) is a nonprofit corporation that was recently formed to provide administrative and technical services to support California and other entities in their implementation of cap-and-trade programs. WCI, Inc. will (1) develop a compliance tracking system for both allowances and offsets credits, (2) administer allowance auctions, and (3) conduct market monitoring of allowance auctions and allowance and offset credit trading. WCI, Inc. is governed by a six-member board, which includes two members of ARB and representatives from Quebec and British Columbia.

California state agencies are subject to what are commonly referred to as "sunshine laws," which generally require that the meetings, decisions, and records of these agencies be made accessible to the public. Under current law, a state agency is defined as a state office, officer, department, division, bureau, board, or commission. Based on an oral opinion we received from Legislative Counsel, since the definition of state agency is somewhat limited, WCI, Inc. would generally *not* be considered a state agency and thus, in and of itself, would likely not be subject to the above sunshine laws. However, we are advised by Legislative Counsel that the Bagley Keene Open Meetings Act (which requires that meetings of public bodies be accessible to the public) and the Public Records Act (which requires that writings of public officials and agencies be accessible to the public) apply not only to state agencies but also to boards on which members of a state agency serve in their official state capacity—regardless of whether the board is organized and operated by a state agency or a private corporation. Therefore, because two members of ARB are on the board of WCI, Inc., WCI, Inc. is in effect subject to the Public Records Act and the Bagley Keene Open Meetings Act.

The Public Contract Code governs the procurement of goods, services, and public works. While a large portion of WCI, Inc.'s operating budget is funded by California, the state does not have full authority over this entity, including how money is being spent on its behalf. It is also unclear whether California has any auditing control over WCI, Inc. According to Legislative Counsel, while contracts that WCI, Inc. enters into with third parties are not subject to the Public Contract Code, contracts that ARB enters into with WCI, Inc. would be subject to the Public Contract Code.

***6. What form might different derivative instruments take in the markets (e.g., insurance for non-compliance, insurance against high or low allowance prices, etc.)?***

Derivatives can broadly be categorized by (1) the relationship of the contract between the underlying asset and the derivative (such as a contract between two parties to buy or sell an asset at a specified future time at a price agreed upon today), (2) the type of underlying asset (such as a foreign exchange derivative or, in this case, a cap-and-trade allowance), and (3) the market in which the parties trade (such as an exchange-traded market like the Chicago Mercantile Exchange). As discussed earlier, derivatives are primarily used for hedging and investment and therefore help parties who have price exposure transfer some of their risk to other parties. It is possible for derivatives to emerge that would serve as a type of insurance or hedge to reduce the risks borne by covered entities associated with the volatility of allowance prices or non-compliance. While covered entities are more likely to have price exposure due to their compliance obligation, trade in derivatives of California's cap-and-trade allowances and offset credits will not be limited to covered entities. In fact, it is quite possible that a wide range of derivatives could emerge as a result of the implementation of the cap-and-trade program. For example, it is likely that derivatives will be developed for investors who wish to bet that the price of allowances will either increase or decrease over time.

***7. Are the emissions allowances or offset credits securities under federal or state securities laws?***

As previously discussed, a carbon allowance is a limited tradable authorization to emit up to one metric ton of CO<sub>2</sub>e and an offset credit is a tradable instrument issued by ARB that represents a GHG reduction of one metric ton of CO<sub>2</sub>e. A "security" is a financial instrument such as notes, stocks, bonds, and similar items, as well as documents traded for speculation or investment. The U.S. Securities and Exchange Commission has not yet sought to regulate carbon trading. According to ARB, allowances and offsets are considered to be commodities. As such, ARB indicates that the allowances would be subject to rules that govern commodities, such as the federal Commodity Exchange Act and its regulations.

***8. What will the role of third party contractors be in administering the auctions, and does this raise any issues of concern to the LAO?***

According to its by-laws, WCI, Inc. will develop, implement, and maintain the capability to execute the auctions of allowances. According to ARB, WCI, Inc. is modeled based on other regional cap-and-trade systems (such as RGGI). The ARB also indicates that coordinating auctions and oversight activities between California and other WCI, Inc. participants will achieve efficiencies. While this is likely true, because WCI, Inc. is currently not subject to the Public Contract Code (aside from contracts entered into with ARB), its contracting activities are not subject to the same level of transparency in California as those contracts entered into by a state agency. For example, the Legislature would not be in a position to exert authority over WCI, Inc.'s contracts since the state does not have full authority over this entity. Such potential lack of transparency could raise concerns. Moreover, it is unclear how ARB plans to review WCI, Inc.'s activities. The Legislature will want to make sure that the ARB has a transparent review system in place in order to ensure that the Legislature has adequate insight into the contractual activities of WCI, Inc.

***9. In the event of litigation involving the cap-and-trade auctions, how will defense of the suits be funded?***

The defense of any challenges to the cap-and-trade regulation would likely be funded from the AB 32 Cost of Implementation (COI) Fee, which was authorized by AB 32. (The ARB assesses this fee on covered entities that are subject to the cap-and-trade regulation in order to pay the state's administrative costs for implementing the statute.) Currently, COI fee revenue supports legal staff at ARB to work on the implementation of programs developed in response to AB 32, as well as associated lawsuits. The ARB legal and program staff currently supporting cap-and-trade activities would likely be drawn on to assist in any potential future litigation associated with the cap-and-trade regulation.

***10. Your analysis of actions that ARB should take to ensure that ARB, CalEPA, the Governor, and the Legislature provide adequate oversight of carbon markets under cap-and-trade.***

As we discussed in our February 2012 report on cap-and-trade, oversight of cap-and-trade auctions and markets is important because of the potential for "gaming"—market manipulation through collusion or fraud. Such activities tend to distort market price signals with potentially significant consequences. The ARB's regulations include several components intended to address the potential gaming of its cap-and-trade program. For example, the ARB is contracting with an independent market monitoring service to detect potential market manipulation. As previously indicated, ARB is assembling a market surveillance committee. As possible options to increase legislative oversight of the cap-and-trade program, the Legislature could consider requiring ARB to include legislative representation—either as a participant or observer—on the market surveillance committee. Similarly, the Legislature could have a representative from the California Independent System Operator (CAISO) participate and provide advice to the committee. (We discuss CAISO's expertise in this area in more detail below.) The Legislature could also require ARB to periodically report on market oversight and developments as they relate to the cap-and-trade program.

***11. Your view on whether other state agencies might play a useful role in carbon market oversight, based on existing expertise in those areas. In particular, would the California Energy Commission be in a better position to provide market oversight?***

The California Energy Commission is the state's primary energy policy planning agency and it has valuable expertise in energy demand forecasting. However, as it does not operate a market, we do not find that it would necessarily be in a better position to provide market oversight. In comparison, we believe that the CAISO may be well suited to provide market expertise and advice to ARB regarding market oversight. While it is not a state agency, it was established to operate the state's wholesale transmission grid in 1996. It is a quasi-governmental agency—organized as a not-for-profit corporation—that is governed by a board of gubernatorial appointees. However, its activities and tariffs are regulated by the Federal Energy Regulatory Commission (FERC). Specifically CAISO is responsible for (1) allocating space on transmission lines, (2) maintaining electricity operating reserves in order to meet reliability standards, and (3) matching electricity supply with demand. As part of these responsibilities, it operates the California wholesale electricity market, which includes the "real-time electricity spot market."

This market involves the procurement of energy to balance instantaneous demand, reduce supply if demand falls, and in extreme conditions, curtail electricity demand.

In view of the above, CAISO has established a rigorous set of protocols for monitoring market activity. For example, CAISO's market monitoring division is responsible for evaluating market performance in order to identify potential anti-competitive market behavior and report market rule violations to FERC for enforcement. In addition, CAISO has organized a market surveillance committee which provides expert advice to improve market oversight. As CAISO currently operates a very complex market, it would be beneficial for it to share with ARB what it has learned from its experiences. Such sharing of expertise could help improve ARB's overall market oversight of the cap-and-trade program.

*12. Would LAO be able to develop the type of market flow chart, with corresponding points of oversight? Should ARB be required to prepare such?*

Attached to this letter is a series of tables that we received from the ARB that summarizes various market oversight activities related to the cap-and-trade program.

I hope this information addresses your questions. If you have any further questions, please feel free to contact Tiffany Roberts of my staff at (916) 319-8309 or [Tiffany.Roberts@lao.ca.gov](mailto:Tiffany.Roberts@lao.ca.gov).

Sincerely,



Mac Taylor  
Legislative Analyst

Attachment

# ATTACHMENT (PROVIDED BY THE AIR RESOURCES BOARD)

**Table 1: Auction Oversight**

Highlights of Market Oversight Activities	Statutory/Regulatory Authority (if appropriate)
<p>Auction design features that promote market oversight objectives:</p> <ul style="list-style-type: none"> <li>• Single round, sealed bid, uniform price auction to deter collusion through signaling.</li> <li>• Auction open to all bidders to promote liquidity and price discovery.</li> <li>• Purchase limit to deter exertion of market power in the auction itself.</li> <li>• Financial assurance required in advance to ensure bidders can execute their purchases and prevent fake bids from disrupting the auction.</li> <li>• The auction floor price was created for multiple reasons, including that it limits gains from trying to manipulate the auction price downward.</li> </ul>	<p>General Statutory Authority: Health and Safety Code sections 38562, 38570. California Cap-and-Trade Regulation provisions, which are in the California Code of Regulations, title 17 Sections 95911(a) (single round, sealed bid provision), section 95911(c) (purchase limit), and section 95911(h) (financial assurance)</p>
<p>Auction analyses that promote market oversight objectives:</p> <ul style="list-style-type: none"> <li>• Ensure financial assurance is adequate to cover bids. Only accept bids that are covered by the financial assurance.</li> <li>• Ensure related entities disclose their relationships and apply purchase limits to related entities.</li> <li>• Independent expert analysis of auction bids to determine that the auction is competitive and free of inappropriate behavior.</li> </ul>	<p>General Statutory Authority: Health and Safety Code section 38562, 38570. Cap-and-Trade Regulation provisions: section 95911(h) (financial assurance), section 96833 (disclosure of direct and indirect corporate associations), section 95911(d) (holding limit generally), section 95914(e) (application of holding limit to corporate associations) ARB's enforcement/implementation/ongoing duties include contracting with third parties to analyze data to help ensure the auction is competitive.</p>
<p>Auction mechanics that promote market oversight objectives:</p> <ul style="list-style-type: none"> <li>• Executive Officer certifies the auction results only after it is determined that the procedures were properly followed and the auction is free of inappropriate behavior.</li> <li>• Release of auction clearing price information and aggregate auction result information to provide transparency.</li> <li>• Individual bidder information and purchases retained as confidential to prevent the disclosure of bidding strategies.</li> </ul>	<p>Section 95912(k) (Executive Officer certification); section 95912(f) (release of names of bidders, auction settlement price and aggregated information on purchases); section 95912(f) (confidential business information from individuals will be maintained as confidential)</p>

**Table 2: Secondary Market Oversight**

Highlights of Market Oversight Activities	Statutory/Regulatory Authority (if appropriate)
<p>Secondary market design features that support market oversight objectives:</p> <ul style="list-style-type: none"> <li>• All allowances (and offset certificates) exist solely in the Compliance Instrument Tracking System Service (CITSS) and consequently all holdings are transparent to regulators.</li> <li>• All entities holding and trading allowances must have accounts on the CITSS. Consequently, all entities have a regulatory relationship with ARB, enabling ARB to impose requirements on all holders of allowances.</li> <li>• Holding limit to deter the exertion of market power in the secondary market.</li> <li>• The Allowance Reserve was created for multiple reasons, including that it limits gains from trying to manipulate the price upward.</li> </ul>	<p>Section 95820 (Compliance Instruments Issued by ARB), section 95830 (registration with ARB), section 95830 (Registration with ARB), sections 95831 &amp; 95832 (Creation of accounts for compliance entities), section 95920 (holding limit), section 95831(b)(4) (creation of allowance price containment reserve).</p>
<p>Secondary market analyses that promote market oversight objectives:</p> <ul style="list-style-type: none"> <li>• Ensure related entities disclose their relationships and apply holding limits to related entities.</li> <li>• Independent expert analysis of trading activities to determine that the secondary market is competitive and free of inappropriate behavior.</li> <li>• Independent Market Surveillance Committee reviewing ARB's market oversight and analysis.</li> </ul>	<p>With the assistance of expert market monitoring contractors, ARB staff will verify compliance with program regulatory requirements, including disclosure of corporate associations. Contracted market monitoring experts will conduct daily reviews of market data to detect potential patterns of inappropriate behavior. ARB will use its regulatory authority to investigate potential inappropriate activity, and may develop enforcement actions with the assistance of the attorney general's office.</p>
<p>Secondary market mechanics that promote market oversight objectives:</p> <ul style="list-style-type: none"> <li>• Executive Officer (EO) can freeze accounts of entities that are not complying with the program rules, including rules regarding transferring allowances between parties.</li> <li>• EO can prevent a transfer if the information provided is inadequate or if inappropriate activity is detected.</li> <li>• Release of aggregate trading information to provide transparency.</li> <li>• Individual holding account information and account transfer information retained as confidential to prevent the disclosure of bidding and holding strategies.</li> </ul>	<p>Section 95914 (EO can restrict or cancel auction participation based on material in the application and otherwise restrict auction access based on misdeeds of participants or failure to disclose information), section 95920 (EO determines a transaction violates the holding limit, shall not approve the transaction); section 96011 (EO has authority to suspend, revoke or modify the holding account of participants in the program); section 95912(f) (release of auction information and retention of confidential information).</p>

**Table 3: Derivatives Market Oversight**

Highlights of Market Oversight Activities	Statutory/Regulatory Authority (if appropriate)
<p>CFTC derivatives market oversight includes:</p> <ul style="list-style-type: none"> <li>Oversight of trading organizations including designated contract markets (DCMs), exempt commercial markets (ECMs), and derivatives clearing organizations (DCOs).</li> <li>DCMs conduct self-regulation under CFTC rules and supervision. DCMs may list for trading futures or option contracts that have been reviewed and approved by the CFTC. The Green Exchange (a DCM) lists California Climate Allowance (CCA) options and futures contracts.</li> <li>The Dodd-Frank Wall Street Reform and Consumer Protection Act eliminated ECMs as a category. Existing ECMs may continue to operate pending final CFTC rulemaking. Existing ECMs may become DCMs or swap execution facilities if they meet the requirements of CFTC rules not yet finalized. The Intercontinental Exchange (ICE), an ECM, lists CCA options and forward contracts for over the counter (OTC) trading.</li> <li>The CFTC's market surveillance program's primary mission is to identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions. Each day, for all active futures and option contract markets, the CFTC's market surveillance staff monitors the daily activities of large traders, key price relationships, and relevant supply and demand factors in a continuous review for potential market problems.</li> <li>The Dodd-Frank Wall Street Reform and Consumer Protection Act provided the CFTC with new authorities to oversee aspects of derivative markets, including OTC trading. Requirements under those authorities are being finalized.</li> </ul>	<p>7 USC § 7, 7 USC § 7a-1 (DCO), 7 USC § 7a-3 (ECMs, were repealed (see below), Pub. L. 111-203, Title VII, § 734(a) (2010)). For self-certification requirements and procedures, see 17 CFR §§ 38.4, 40.2, 40.6.</p> <p>Sections 723 (eliminating ECM), 734 (eliminating EBOT) of the Dodd-Frank Act. See also 75 Fed. Reg. 56513 (September 16, 2010). Information on the CFTC surveillance program is available at: <a href="http://www.cftc.gov/IndustryOversight/MarketSurveillance/CFTCMarketSurveillanceProgram/index.htm">http://www.cftc.gov/IndustryOversight/MarketSurveillance/CFTCMarketSurveillanceProgram/index.htm</a> (accessed January 23, 2012).</p> <p>See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Title VII (2010)).</p>
<p>State action in the derivatives market:</p> <ul style="list-style-type: none"> <li>The ARB is formalizing a working relationship with CFTC to support coordinated oversight and exchange of information.</li> <li>The State Attorney General can bring an action in the derivatives market (with some limitations) in addition to an action by the CFTC.</li> </ul>	<p>The Commodity Exchange Act (CEA) authorizes the CFTC to cooperate with any state, 7 U.S.C. §16(a). The Commodity Exchange Act (CEA) authorizes states to take action, 7 U.S.C. §13a-2. Jurisdiction of States.</p>