

December 17, 2010

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St., NW
Washington, DC 20581

Re: Response of the Coalition for Emission Reduction Projects to the Commodity Futures Trading Commission's Call for Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets, 75 Fed. Reg. 72,816 (Nov. 26, 2010)

Dear Commissioners and Staff:

The Coalition for Emission Reduction Projects (CERP) is pleased to offer the following brief comments in response to the Commodity Futures Trading Commission's (CFTC) recent call for public input¹ in connection with the study of carbon markets required by Section 750 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).²

CERP is a coalition of companies advocating for market-based approaches to the regulation of greenhouse gas (GHG) emissions. Our diverse membership includes companies that develop or finance projects that reduce or sequester GHG emissions, as well as companies that expect to be subject to GHG regulation and want the ability to use offset credits derived from these projects to meet their compliance obligations. Many of our members have years of experience trading GHG allowances and offset credits, and participating in other environmental markets, such as for sulfur dioxide (SO₂), nitrogen oxides (NO_x), and renewable energy certificates. Representing both net sellers and net purchasers of GHG allowances and offset credits, our members share a common interest in ensuring that current and prospective carbon markets are governed by a fair, stable, and

¹ Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets, 75 Fed. Reg. 72,816 (Nov. 26, 2010).

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 750, 124 Stat. 1376, 1748 (2010).

efficient system of rules. To that end, CERP has offered comments on market oversight in regard to a previous CFTC rulemaking implementing the Dodd-Frank Act,³ as well as market oversight proposals being considered by the Western Climate Initiative and the State of California.⁴

Below, the first section of our comments offers general background on the role of market oversight in promoting robust carbon markets as well as the need for appropriate regulatory treatment of certain transactions involving offset credits. This information is responsive to questions 2, 4, 10 and 11 in the call for public input. The second section specifically addresses several of the specific policy-related questions posed by CFTC in the call for public input.

I. Carbon Markets Do Not Require A Fundamentally Different Regulatory Approach From Other Commodities, and Inappropriate Regulation Could Prevent Them From Achieving Cost-Effective Reductions in GHG Emissions

CERP believes there are two central tenets that should guide CFTC's consideration of market oversight of carbon markets.

First, a market in carbon instruments is comparable to other commodity markets, and has no unique vulnerability to fraud or manipulation. As such, the regulatory framework already contemplated under the Dodd-Frank Act is well suited to governing the carbon market. The *environmental* integrity of carbon market instruments is a distinct issue from market integrity, and can only be ensured by environmental regulators.

Second, carbon market participants do have specific needs that can be—and should be—accommodated within the existing regulatory framework of the Dodd-Frank Act. Entities regulated under a cap-and-trade program must be able to affordably hedge their exposure to allowance and offset credit prices. In addition, the owners and developers of offset projects—often small enterprises such as farms and ranches—must be able to attract investment in their projects in exchange for a future stream of offset credits. Such investment will generally take the form of highly non-standardized offset development contracts. In the Dodd-Frank Act, Congress created a carefully balanced regulatory framework capable of accommodating both of these needs. The existing framework appropriately affords an “end user” exception for swaps used for hedging of commercial risk, and allows CFTC to refrain from requiring clearing and exchange trading of non-standardized transactions such as offset development contracts. These aspects of the

³ CERP, Comments of the Coalition for Emission Reduction Projects on Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (submitted Sept. 20, 2010).

⁴ CERP, Comments on the Western Climate Initiative's Draft Recommendations on Market Oversight (submitted May 12, 2010), available at <http://www.westernclimateinitiative.org/public-comments/comment/748>.

current regulatory framework—discussed further below—are essential to the development of a robust carbon market.

A. The Dodd-Frank Act Provides for Effective Oversight of Carbon Markets

In developing recommendations on carbon market oversight, CFTC and the other Federal agencies engaged in the Section 750 study should be mindful that carbon markets—unlike other commodity markets—serve a public policy objective: the achievement of GHG reduction goals at the lowest possible cost. In a cap-and-trade program, the GHG sources to be regulated are placed under an overall “cap” on GHG emissions in the form of a limited quantity of tradable emission rights. Sources covered by the emission cap are required to periodically obtain sufficient quantities of emission rights to cover their GHG emissions. When functioning properly, the price in a carbon market reflects the lowest marginal cost of reducing GHG emissions among the covered facilities—ensuring that those sources that can mitigate their GHG emissions at least cost have an incentive to do so. Cap-and-trade programs are therefore a more economically and administratively efficient alternative to traditional “command-and-control” approaches to environmental regulation, in which individual facilities are subjected to technology-based permitting or standards.

Almost all present and proposed carbon markets recognize two basic types of emission rights: allowances and offset credits. Allowances are issued by the government on a regular basis (either through an auction mechanism or via direct distributions) in an amount corresponding to the quantity of emissions allowed under the cap. By contrast, offset credits are issued (by the government or a private offset registry) *only* when permanent, additional, and verifiable reduction or sequestration of GHG emissions is achieved at an eligible project that is *not* covered by the emission cap. Offset credits play a vital role in carbon markets by allowing sources covered by the emission cap to seek out cost-effective emission mitigation opportunities at projects outside the cap, thereby lowering the cost of compliance. In fact, the Congressional Budget Office’s economic analysis of the American Clean Energy and Security Act of 2009 (the Waxman-Markey bill) determined that the opportunity to obtain domestic and international offset credits would decrease the price of allowances by 69% in 2012.⁵ A successful carbon market thus requires rules that facilitate robust markets for *both* offset credits and allowances.

Although carbon markets are distinctive in that they serve a public policy objective, the trading of allowances and offset credits is equivalent to other commodity markets and does not require fundamentally new approaches to market oversight. Because allowances and offset credits are required for compliance with an environmental program, they are analogous to other necessary inputs for industrial production, such as fuel and raw

⁵ Congressional Budget Office, Cost Estimate for H.R. 2454 at 16 (June 5, 2009), *available at* <http://www.cbo.gov/ftpdocs/102xx/doc10262/hr2454.pdf>.

materials. Allowances and offset credits must be surrendered for compliance at regular intervals, but they can also be acquired at any time and, indeed, most companies are likely to be constantly engaged in purchasing and selling allowances and offset credits in response to price signals.

Regional and national carbon markets are expected to be quite large, with trading values on the order of hundreds of billions of dollars; the scale of these markets would serve as a barrier to any market participant seeking to execute a “corner” or similar manipulative strategy. Moreover, the spot markets in allowances and offset credits are, if anything, more transparent than for other commodities; almost all existing and proposed carbon markets would require public disclosure of the issuance and ownership of allowances and offset credits, allowing regulators to easily track individual instruments as they change hands.

All of these economic features of carbon markets suggest that effective oversight of these markets should be similar to other commodity markets.

Extensive experience with existing environmental markets reinforces this supposition. The U.S. markets for SO₂ and NO_x allowances have functioned smoothly for years, allowing regulated sources to meet their compliance obligations in an efficient and affordable manner. Similarly, the European Union’s Emissions Trading Scheme (ETS) and the Regional Greenhouse Gas Initiative (RGGI) have been operating for several years without any evidence that traditional market oversight has been inadequate.⁶ Although the EU ETS in particular has experienced significant price volatility (due in large part to excessive allocations of allowances in the initial years of the program, not failures of market oversight), there is no indication that it or the RGGI are prone to manipulation, fraud, excessive speculation, or systemic failure.⁷

⁶ Although certain types of transactions in the EU ETS have come under regulatory scrutiny and public criticism, these transactions do not involve traditional market oversight concerns such as manipulation or excessive speculation. For example, in 2009 it was revealed that many EU ETS transactions were affected by “carousel fraud,” in which traders of ETS allowances evaded the payment of value added taxes (VAT). This type of tax evasion is not unique to ETS allowances and can presumably be addressed through improved enforcement of tax laws. In addition, the government of Hungary came under criticism for “recycling” offset credits that had already been retired for compliance to organizations outside the EU ETS, raising the possibility of “double counting” emission reductions. This activity reflects a flaw in policies governing the environmental integrity of the ETS, not a failure of market governance.

⁷ See generally A. Danny Ellerman & Paul L. Joskow, *The European Union’s Emissions Trading System in Perspective* (Pew Center for Global Climate Change, May 2008) (concluding that EU ETS is a generally sound trading platform and that price volatility in EU ETS allowances is comparable to energy commodities); Mark Jickling and Larry Parker, *Regulating a Carbon Market: Issues Raised by the European Carbon and U.S. Sulfur Dioxide Allowance Markets* (Congressional Research Service No. RL34488, 2008). A recent study by the Government Accountability Office (GAO) also found, among other things, that the regulatory risks posed by carbon markets are comparable to those of other commodities; that the size of the carbon market lowers the risk of successful market manipulation; and that regulators have not identified fraud in U.S. carbon markets.

For these reasons, CERP believes that the existing framework for Federal regulation of commodity markets, as it was most recently amended in the Dodd-Frank Act, is well adapted to regulating the carbon market. There is simply no reason to believe that the CFTC’s recently-expanded suite of regulatory tools and authorities—including required clearing and exchange trading of standardized swaps and futures; authority to set position limits across derivative markets, including over-the-counter swaps with a significant price discovery function; mandatory reporting of all swaps, including over-the-counter swaps; mandatory reporting of spot and derivative transactions undertaken by “large traders”; and authority to enforce rules against manipulation and fraud in commodities trading—are inadequate to the task of regulating carbon markets. Moreover, the Dodd-Frank Act reflects an appropriate policy judgment by Congress that swaps undertaken by non-financial entities for hedging purposes should not be subject to burdensome clearing and exchange requirements. This judgment applies equally well to carbon markets, in which many entities will be required by law to participate and will have legitimate needs to hedge their exposure to allowance and offset credit prices. This balanced framework should allow for the development of a well-regulated carbon market characterized by a large and diverse cast of participants, and liquid trading in both spot and derivative markets.

B. Special Considerations Applicable to the Offset Markets

CERP also urges that any recommendations offered in the Section 750 study recognize that it is inappropriate to subject contracts that enable the *issuance* of offset credits to clearing and exchange requirements designed for standardized, high-volume contracts.

By way of background, offset credits tend to be issued following a fundamentally similar process regardless of which organization issues them. First, the issuer of offset credits selects protocols specifying which types of offset projects are eligible to receive credits, what limitations apply (for example, with respect to the timing of project commencement and duration of emissions crediting), and how emission reductions from those projects are to be calculated and verified. Second, a project sponsor seeking to receive offset credits must register the project with the issuer, supplying any project information and third-party validation that may be required. After the project is registered and commences operation, resulting emission reductions or sequestration are verified by a third party and offset credits are issued to the sponsor accordingly. Therefore the environmental integrity of an offset credit is regulated by the offset registry.

Although offset credits are generally interchangeable with allowances once issued, the *issuance* of offset credits almost always results from unique contracts that are tailored

GAO, *Carbon Trading: Current Situation and Oversight Considerations for Policymakers* at 7, 22-23 (Aug. 19, 2010).

to the risk profile of each individual project. To obtain finance for a future offset project, developers of offset projects frequently sign agreements—known as emission reduction purchase agreements or offset development contracts—with prospective offset credit buyers, in which the developers commit to sell the buyer a specified quantity of offset credits once the project begins operation. Sometimes, the project agreement also provides the investor with an option to purchase offset credits. Offsets can also be sold “unit contingent,” where a buyer agrees to purchase all of a certain vintage of offset credits produced by a project, or all credits produced in specified months subject to a cap. Such arrangements are often made in exchange for partial prepayment or early finance in the offset project—a vital source of start-up funding for offset projects, which often have few potential revenue streams apart from the offsets they generate and which are often sponsored by capital-constrained entities. These transactions are intended to be physically settled and, assuming the project is ultimately successful, result in actual delivery of offset credits.

Because these contracts are individually negotiated to reflect the size and particular risks associated with each project, as well as the financial circumstances of the parties, these contracts are *not* fungible with each other and are not marketed to the public or otherwise actively traded. To our knowledge, offset development contracts have not been traded on exchanges or cleared by clearinghouses, nor is it clear that they ever could be. Indeed, our understanding is that offset development contracts for Clean Development Mechanism (CDM) projects have taken place entirely over-the-counter, with active exchange trading of the resulting offset credits taking place in the EU ETS only with respect to offset credits that have already been issued and introduced into the secondary market. Furthermore, many offset project sponsors are farms, ranches, forest owners, and other small enterprises that have little wherewithal to sustain the high transaction costs (such as margin requirements) associated with clearing and exchange trading.

Some legislative proposals considered in the 111th Congress—in particular, the Feinstein-Snowe bill and the Kerry-Lieberman bill—included overbroad clearing and exchange requirements that would likely have applied even to offset development contracts. It seems probable that these provisions were drafted without a full understanding of the nature of offset creation contracts or the impact of such requirements on the farmers, ranchers, and other small enterprises likely to host offset projects. As indicated above, such requirements would prove simply unworkable for most offset development contracts, or at best would prove prohibitively costly to meet for most potential offset project sponsors. Such requirements would severely limit the universe of financially viable offset projects and constrict the supply of cost-effective offset credits. Moreover, clearing and exchange requirements would have the effect of limiting participation in offset development contracts only to large, well-capitalized entities capable of making the delivery guarantees and posting the margin required by exchanges. In so doing, such regulations could perversely aggravate market power concerns by erecting high barriers to entry in the primary offset market.

In stark contrast to their clear costs, these requirements would make no discernible contribution to the integrity of the overall carbon market. Offset development contracts are essentially inextricable from individual projects and, as such, it is difficult to see how systematic manipulation of this market (by either developers or purchasers) could even occur. In observing the growth of the offset credit market over the last decade, we have not seen any evidence that the contracts enabling offset project development are being manipulated or are susceptible to dangerous speculation. Indeed, the existing primary market for offset credits is characterized by a high diversity of small and medium-sized sellers, as well as a large number of buyers with low barriers to entry. Inappropriate regulation of offset development contracts could disrupt this healthy competitive balance by shutting out all but the largest institutions and financial entities from the marketplace.

CERP respectfully submits that with respect to offset development contracts (as opposed to transactions involving offset credits that have already been issued), there is simply no basis for recommending additional market oversight and strong reason to believe that inappropriate trading requirements would have counterproductive effects on the carbon market. CERP also notes that under the Dodd-Frank Act, clearing and exchange requirements are likely to not apply to most offset development contracts. This reflects Congress' careful judgment in the Dodd-Frank Act that forward sales, non-standardized contracts that are not amenable to clearing, and legitimate hedging transactions—all descriptions that apply to most development contracts—should not be subject to burdensome transactional requirements. For the reasons stated above, we see no reason why that judgment is inadvisable for offset development contracts.

Lastly, CERP recognizes that the environmental integrity of offset credits is an important policy concern. Because the market value of offset credits depends heavily on the credibility of their underlying environmental benefits, CERP members are also committed to ensuring that offset credits represent genuine reduction or sequestration of GHG emissions. That said, the authors of the Section 750 study should distinguish policy concerns relating to the *financial integrity* of the offset credit market (the proper domain of CFTC) and the environmental integrity of offset credits themselves (an appropriate concern for environmental regulators). Today, the environmental integrity of CDM offset credits—which represent the bulk of offset credits circulating today—is carefully overseen by the CDM's Executive Board. Any future compliance-based offset credit system in the U.S. is also likely to be heavily regulated by environmental agencies. For example, major Congressional proposals for cap-and-trade programs included extensive and detailed provisions requiring the Environmental Protection Agency (and in some cases the U.S. Department of Agriculture) to prescribe rigorous protocols for the issuance of offset credits from both domestic and international offset projects. Ultimately, the environmental integrity of offset credits depends on the registration, measurement, and verification protocols created through such systems of environmental regulation. Financial regulation of offset development contracts would do nothing to further ensure the quality of offset

credits. Thus, we believe it is inappropriate for the Section 750 study to explore or issue recommendations relating to environmental integrity of offset credits.

II. Responses to Specific Questions in Call for Public Input

In addition to our comments above, which generally respond to questions 2, 4, 10, and 11 in the CFTC's *Federal Register* notice, we offer comments on the following specific queries in the call for public input.

Question 1. Section 750 of the Dodd-Frank Act indicates that the goals of regulatory oversight should be to ensure that carbon markets are efficient, secure, and transparent. What other regulatory objectives, if any, should guide the oversight of such markets?

As indicated above, CERP believes that the oversight of carbon markets should recognize the primary objective of ensuring that these markets fulfill their public policy function of securing GHG reductions at lowest possible cost. Implicit in this objective are the corollaries that market oversight rules should keep transaction costs as low as possible so as to maximize the volume of welfare-enhancing transactions and ensure the participation of small and medium-sized firms; enable a wide variety of legitimate hedging techniques to manage compliance costs and facilitate price discovery; facilitate investment in offset projects by recognizing the non-standardized nature of offset creation contracts; and promote the development of liquid markets for both allowances and offset credits. These objectives are all the more imperative given that the carbon markets are compliance markets in which participation is mandatory for some entities.

Question 2. What are the basic economic features that might be incorporated in a carbon market that would have an effect on market oversight provisions?

Above, we explain that the characteristics of allowances and offset credits do not significantly distinguish them from other commodities in a way that justifies radically new approaches to market oversight. In addition to those observations, the Section 750 study should recognize that offset credit availability is a key cost containment mechanism for carbon markets and a way of providing limited supply elasticity in the event of high allowance prices. The Section 750 study should acknowledge that this mechanism can only function if the transaction costs associated with development of offset projects are kept low enough to enable the participation of small and medium-sized companies in the market.

CERP also believes that open and diverse participation should be an essential economic feature of a carbon market. To function properly and protect against manipulation and excessive volatility, carbon markets must develop high levels of liquidity both in the form of spot and derivative transactions. This imperative requires that the carbon markets be open to a large number of well-capitalized participants and (especially

for the development of derivatives markets) that the participants have sufficient diversity of hedging requirements and market expectations to serve as “natural counterparties.” It is therefore inappropriate for carbon markets to be restricted to limited categories of participants, such as only compliance entities.

Question 4. Are additional statutory provisions necessary to achieve the desired regulatory objectives for carbon markets beyond those provided in the Commodity Exchange Act, as amended by the Dodd-Frank Act, or other federal acts that may be applicable to the trading of carbon allowances?

No. As explained in more detail above, the Dodd-Frank Act provides CFTC with significant new regulatory powers that could be effectively applied to the carbon markets.

Question 10. Based on trading experience in SO₂ and NO_x emission allowances what regulatory oversight would market participants and market operators, respectively, recommend?

Please refer to our comments in Section 1 of this memorandum on the general absence of manipulation, fraud, or excessive speculation in the SO₂ and NO_x markets.

Question 11. Who are the primary participants in the current primary environmental markets? Who are the primary participants in the current secondary allowance and derivatives environmental markets?

In addition to our comments above on the role of project developers in ensuring that offset credits are generated and brought to market, CERP emphasizes that *aggregators* play a vital role in the offset credit market that should be protected and encouraged. Aggregators are firms that “bundle” offset credits from multiple offset projects—usually small projects which might otherwise find it costly to locate buyers for their offset credits—for further sale in the secondary markets. These firms help lower the transaction costs associated with bringing offset credits to market, enabling both a larger supply of viable offset projects and a more liquid secondary market for offset credits. CERP believes the Dodd-Frank Act provides CFTC with appropriate tools to monitor aggregators and ensure the integrity of these transactions, without stifling the contributions aggregators make to the carbon markets.

III. Conclusion

CERP appreciates CFTC's call for public input on the Section 750 study, and would welcome the opportunity to engage further with CFTC and the other Federal agencies participating in this effort. Please do not hesitate to contact us with questions or to request further information.

Respectfully submitted,

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