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David A. Stawick  
Secretary of the Commission  
Commodity Futures Trading Commission  
1155 21st Street, N.W.  
Washington, DC 20581

**Re: Comments on the CFTC's Request for Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets, 75 Fed. Reg. 72816 (November 26, 2010)**

Dear Mr. Stawick:

The Edison Electric Institute ("EEI") respectfully submits these comments in response to the Commodity Futures Trading Commission's ("Commission" or "CFTC") notice and request for comment ("Notice") published November 26, 2010 in the Federal Register. In the Notice, the CFTC requests public input to the interagency working group that is required to conduct a study on the oversight of existing and prospective carbon markets to ensure an efficient, secure, and transparent carbon market, including oversight of spot markets and derivative markets, as required under Section 750 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").<sup>1</sup>

EEI appreciates the opportunity to submit comments on this important topic. While today's carbon markets are relatively small in the United States, consisting of a limited regulatory compliance market under the Regional Greenhouse Gas Initiative ("RGGI") covering ten Northeastern and Mid-Atlantic states, and a nascent voluntary market, the use of carbon markets is expected to expand under future state, regional and/or national regulation.

**I. Description of EEI and its Interest in the Study Regarding the Oversight of Existing and Prospective Carbon Markets**

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<sup>1</sup> Pub. L. No. 111-203 (2010) (to be codified as an amendment to the Commodity Exchange Act in scattered sections of 7 U.S.C. ch. 1 (the "Commodity Exchange Act" ("CEA"))) ("Dodd-Frank Act").

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry. EEI also has more than 65 international electric companies as Affiliate members, and more than 170 industry suppliers and related organizations as Associate members.

Organized in 1933, EEI works closely with all of its members, representing their interests and advocating equitable policies in legislative and regulatory arenas. EEI provides public policy leadership, critical industry data, market opportunities, strategic business intelligence, conferences and forums covering all aspects of the electricity industry, and various products and services to serve the needs of our members and other participants in the electricity industry.

As the sector responsible for approximately one-third of U.S. greenhouse gas emissions ("GHGs"), the electric sector will be undoubtedly be impacted by future legislative and regulatory schemes that seek to reduce GHGs. Ensuring that the carbon markets that will develop as a result of future legislation or regulation are well functioning, fair, and efficient is therefore a primary concern of the Edison Electric Institute and its members.

## **II. EEI Comments on the Questions Presented in the Notice**

### ***1. Section 750 of the Dodd-Frank 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?***

Carbon markets, and other emission markets, are unique in that they are a construct that exists due to legislation and or regulation. Legislators or regulators have chosen to utilize emission markets for the express purpose of allowing market-based principles to achieve least-cost compliance while meeting an environmental target. Oversight of these markets must, as the CFTC recognizes, ensure that that the markets are efficient, secure and transparent. However, caution should be exercised that regulation designed to safeguard these markets does not place burdens on the market that thwart the public policy goal of achieving least-cost compliance.

For the electric power sector, which is expected to be one of the most impacted end-user categories participating in carbon markets, allowing emission markets to operate in a manner that allows end users to achieve least-cost compliance will ultimately help maintain the affordability of electricity for consumers. Minimizing the additional costs that potential market oversight provisions place on the emission markets therefore needs to be a primary objective of regulators.

To achieve the needed efficiencies that will lead to least-cost compliance, carbon markets must:

- *Maximize participation to allow for high liquidity.* Markets that are not liquid can lead to higher prices, fewer compliance choices for end users, and the potential for manipulation.
- *Keep the cost of participation in the market low for end users.* Since environmental markets are by design meant to place a “price” on emissions, they achieve their goal by increasing the cost of the underlying commodity (*i.e.*, electricity in the case of electric utilities.) That higher price sends the needed signal to reduce emissions to the target set by legislators or regulators. Additional costs due to overly prescriptive market oversight burdens would increase costs but provide no additional environmental benefit.
- *Foster innovation that allows for flexible transaction structures, including the use of physical and financial (*i.e.*, derivative) transaction settlement mechanisms.* There has been much innovation in the existing NO<sub>x</sub> and SO<sub>2</sub> markets. Contractual arrangements between parties have included inter-pollutant swaps (*i.e.*, NO<sub>x</sub> allowances for SO<sub>2</sub> allowances); coal contracts that have guaranteed the sulfur content of coal would not exceed contract levels through the delivery of SO<sub>2</sub> allowances if thresholds were exceeded; and pollution control equipment performance guarantees that were backstopped by allowance deliveries if guarantees were not met. This innovation has aided industry in its efforts to minimize the cost of reducing emissions and has helped spur deployment of promising new technologies. Regulators should not place burdens on emissions markets that would cancel the innovation that market-based solutions have delivered to date and will continue to deliver to the marketplace while achieving substantial emission reductions.
- *Provide for certainty of regulation.* Markets require a degree of stability for efficient, cost-effective operation. Rules that are unknown or remain in flux would discourage end users from participating and run counter to the public policy goal of achieving least-cost compliance through the robust use of market mechanisms. In a similar fashion, duplicative or overlapping authority between agencies will lead to confusion. This is especially true if regulators in different agencies set different or conflicting rules, thereby unnecessarily increasing the cost of using these markets for compliance.

2. *What are the basic economic features that might be incorporated in a carbon market that would have an effect on market oversight provisions--e.g., the basic characteristics of allowances, frequency of allocations and compliance obligations, banking of allowances, borrowing of allowances, cost containment mechanisms, etc?*

Carbon markets are likely to develop like any other commodity market. Therefore, CFTC's market oversight should be similar to regulating any other commodity market. Specific aspects, such as allowances allocation levels or formulas, decisions as to whether to auction or allocate allowances, and the use of cost-containment mechanisms (such as the use of banking or borrowing) are policy decisions that we believe are independent of the market oversight. It is hard to imagine, for example, that market oversight would be different if legislators or regulators chose to include the use of banking or not. Therefore, EEI believes the Section 750 interagency working group should focus on being responsive to Congress's request on providing recommendations germane to the oversight of market, and should not deliver to Congress specific recommendations on public policy aspects of potential future compliance programs, such as whether such a future program should allow the inclusion of banking. Similarly, while the creation of an allowance through the use of an "offset" is somewhat unique to the carbon markets, EEI believes that the criteria for what qualifies as an offset is not a financial issue to be resolved by the CFTC. For the CFTC to stray into those areas would exceed the scope of Congress's intent and request.

3. *Do the regulatory objectives differ with respect to the oversight of spot market trading of carbon allowances compared to the oversight of derivatives market trading in these instruments? If so, explain further.*

The regulatory objectives should be the same, i.e., to ensure an efficient, transparent, and well functioning market that has minimal opportunities for gaming and manipulation. Spot and derivatives markets both play a critical role in price discovery and risk management.

Further, the unique nature of the allowance markets must recognize that contracts for emission offsets during their primary "creation" phase are subject to highly specialized, complex, and unique contract structures that cannot be readily standardized for trading via an exchange-only market. Regulators must allow for a spot market and OTC trading of emission offset contracts in recognition of this unique nature. Attempts to force standardization and allow only exchange trading of offset contracts will undermine one of the most basic cost-containment tools available to the industry. EEI has long advocated for the use of emission offsets in any future regulatory scheme to achieve the goal of least-cost compliance for our consumers. Regulators must recognize the unique nature of offsets, and allow OTC trading of these instruments, so as not to undermine the public policy goal that offset use is trying to achieve.

- 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?***

Carbon markets, e.g., GHG allowances, are no different than other energy commodities. Therefore, no additional statutory provisions are necessary. Having consistency in market rules for different commodities will lead to lower overall compliance costs, and ensure that carbon markets have the same level of oversight and accountability as other commodities markets utilized within the energy sector. Having a single set of principles and clear lines of market oversight authority will help ensure consistent compliance by end users without placing unnecessary burdens or costs on industry.

- 5. *What regulatory methods or tools would be appropriate to achieve the desired regulatory objectives?***

The regulatory methods and tools being developed for other commodity markets to meet the requirements of Dodd-Frank would be equally appropriate to achieve desired regulatory objectives in regulating carbon markets. As discussed in response to question 10, below, to EEI's knowledge, there are no known allegations of fraud or manipulation that have surfaced in the federal NO<sub>x</sub> and SO<sub>2</sub> markets, a testament that the existing oversight structure is providing the needed safeguards.

- 6. *What types of data or information should be required of market participants in order to allow adequate oversight of a carbon market? Should reporting requirements differ for separate types of market participants?***

As already discussed emission markets should not be differentiated from other commodity markets and reporting requirements should be consistent with the reporting requirements placed on end users in the other commodity markets. Market regulators, to the extent possible, should also consider relying on the compliance reporting systems that will be utilized by environmental regulators for tracking compliance. For example, the Environmental Protection Agency already tracks the ownership of allowances for the express purpose of determining compliance with the environmental goal of a program. Those data are publicly available and could be utilized in part by market oversight regulators without the need to construct a duplicative tracking system or registry.

- 7. *To what extent is it desirable or not desirable to have a unified regulatory oversight program that would oversee activity in both the secondary carbon market and in the derivatives markets?***

A single market regulator, such as the CFTC, is the preferred approach. For example, there have been proposals to split regulation of the spot market and derivatives markets between different federal agencies. Any approach that bifurcates market oversight will only lead to duplicative reporting, potentially conflicting regulations, and increased cost. It may also lead to confusion between regulatory agencies and could lead to the unfortunate circumstance whereby an entity would seek to exploit any gaps in coverage or loopholes between differing regulations at different agencies.

**8. *To what extent, if any, and how should a US, regulatory program interact with the regulatory programs of carbon markets in foreign jurisdictions?***

If a U.S. carbon market is “linked” to another carbon market in a foreign jurisdiction, then it will be imperative for the U.S. regulatory program to interact with the regulatory oversight of the foreign market. As is currently done with other commodities, to the extent there is linkage of a U.S. based system with foreign markets, the necessary safeguards will be needed to prevent an entity from “off shoring” its trading activity with the intent of hiding its cumulative positions or manipulating the markets.

**9. *What has been the experience of state regulators in overseeing trading in the regional carbon markets and how would that instruct the design of a federal oversight program?***

State regulatory experiences may have limited applicability. For example, RGGI and the Chicago Climate Exchange (“CCX”) allowance prices have both recently been less than \$2 per metric ton, primarily due to either a liberal cap (RGGI) or a voluntary nature (CCX). In addition, these markets have had few financial participants. The California market is just beginning, with just two demonstration trades announced, so there is little experience in that state. Experience regulating oversupplied or voluntary markets with few financial participants, and little or no need for offsets is not likely to provide significant guidance.

**10. *Based on trading experiences in SO<sub>2</sub> and NO<sub>x</sub> emission allowances what regulatory oversight would market participants and market operators, respectively, recommend?***

Given that the Dodd-Frank Act is now in the process of strengthening the basic oversight provisions for all commodities markets, there is no need for separate or additional regulatory oversight of emission markets. Experience in the existing NO<sub>x</sub> and SO<sub>2</sub> markets has shown these markets are capable of providing the least-cost public policy solution that they were designed to achieve. These markets have been robust, transparent, and cost-effective under the existing basic oversight provisions of the Commodity Exchange Act, and have functioned well without the need for additional regulatory burden beyond the regulations that currently applied to both the spot and derivatives markets for other commodities. In fact, to EEI’s knowledge, there are no

known allegations of fraud or manipulation that have surfaced in the NO<sub>x</sub> and SO<sub>2</sub> markets, a testament that the existing oversight structure is providing the needed safeguards. In addition, as previously noted, having a single set of regulatory rules applied to all commodities that non-financial end users, such as electric utilities, utilize will lower the overall cost of compliance – without impacting the integrity of these markets.

***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?***

As we noted in our response to Question 1, in addition to the end users required to hold allowances to achieve compliance, fuel producers and equipment manufacturers have participated in the market and offered unique, customized contractual products that have relied on the emissions markets. In the carbon market, these same entities are likely to be participants, as well as others including offset developers, banks, hedge funds and others. All help provide the liquidity and flexible contract structures that are necessary to ensure the goal of achieving least-cost compliance with an environmental target.

**III. Conclusion**

EI appreciates the ability to comment on the Notice and supports the goals of ensuring an efficient, secure, and transparent carbon market.

EI respectfully requests that, in addition to taking comment through this notice, that the CFTC also publish its report in draft form and allow the public to provide specific comment on any recommendations or findings *before the report is finalized and presented* to Congress.

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Respectfully submitted,



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