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Re: Comments of the American Wind Energy Association on the Proposed Further Definition of a Swap and Adaptation of Regulations to Incorporate Swaps

Submitted via Federal Rulemaking Portal: http://www.regulations.gov

On May 23, 2011, the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") published a joint Notice of Proposed Rulemaking on the "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping" ("Swap NOPR"),[1] seeking comments on the proposed definition of the term "swap" under the Commodity Exchange Act ("CEA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2]

The American Wind Industry Association ("AWEA") hereby submits the following comments[3] in response to Question 32 of the Swap NOPR.[4] For the reasons discussed

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[1] 76 Fed. Reg. 29,818 (May 23, 2011).

[2] *See Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law 111-203, 124 Stat. 1376 (2010).

[3] AWEA has reviewed a draft of the Environmental Markets Association's ("EMA") comments regarding the SWAP NOPR and generally supports EMA's filing.

[4] *See* Swap NOPR at 29,832. Question 32 asks the following: "Should the forward contract exclusion from the swap definition apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates? If so, please describe these commodities, and explain how transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)? Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?"

herein, we believe forward sales of emissions allowances ("Allowances"), carbon offsets and credits ("Offsets"), and renewable energy certificates ("RECs," and together with Allowances and Offsets "Environmental Commodities") should be subject to the forward contract exclusion in Section 1a47(B)(ii) and, therefore, are not "swaps." Our principal concern in submitting these comments is that the forthcoming rules not inhibit the benefits provided by markets for Environmental Commodities. These markets remain small, notwithstanding their great potential. Regulatory supervision of these markets is welcomed by AWEA and its members. The correct treatment of Environmental Commodities within the new regulatory framework set forth in Title VII of the Dodd-Frank Act is essential to the continued efficient functioning of these markets.

I. Introduction

AWEA is a national trade association representing a broad range of entities with a common interest in encouraging the expansion and facilitation of wind energy resources in the United States. AWEA's members include wind energy facility developers, owners and operators, construction contractors, turbine manufacturers, component suppliers, financiers, researchers, utilities, marketers, customers, and their advocates.

The wind energy industry currently employs 75,000 people in the U.S. and has been one of the few bright spots in a difficult economy. In 2010, the wind energy industry installed 5,116 megawatts ("MW") of capacity, representing $11.1 billion in investment. Total cumulative installed capacity stands at 40,181 MW, and average annual growth for the past five years has been 35 percent. The industry has utility scale wind developments in 38 states and more than 400 manufacturing facilities in 42 states. The industry's potential as a job creation and economic engine is even greater than these numbers would suggest. A U.S. Department of Energy report, issued in July 2008,[5] stated that 20 percent wind energy penetration was conceivable, and if that target were realized, the wind energy industry would support 500,000 jobs.

II. Role of Environmental Commodities

Trading in Environmental Commodities is critical to the deployment of renewable energy, such as wind power. Such trading supports both existing and future demand for renewable energy and makes renewable energy more cost-competitive. For instance, over 30 States and the District of Columbia have Renewable Portfolio Standards ("RPS") that use Environmental Commodities. The majority of states with RPS requirements allow utilities to use RECs for the purpose of establishing compliance with relevant standards.

RECs are created by state regulatory bodies in conjunction with the production of electricity from a qualifying renewable energy facility. The forward sale of RECs transfers

[5] *See* "20% Wind Energy by 2030: Increasing Wind Energy's Contribution to U.S. Electricity Supply." *Available at* http://www.nrel.gov/docs/fy08osti/41869.pdf.

ownership of a REC from the producing entity to another entity that can use the RECs for compliance with an obligation to sell a certain percentage of renewable energy. Many times, this forward sale takes place prior to the construction of a project to enable developers to secure necessary financing.

At the project level, if a forward sale of a REC is considered a swap, the imposition of Title VII's mandatory clearing requirement would mean that a project would need to tie up valuable cash flow as collateral if it relies on RECs as a revenue stream. This requirement would likely negatively impact the economics of wind power projects and their competitiveness as compared with energy projects that does not rely on revenues from REC sales. In futures markets, this minimum margin requirement is typically approximately equivalent to five to fifteen percent of a contract's value. Thus, if a 100 MW wind farm (capacity factor 30 percent) sells forward a 5-year stream of RECs for $2/MWh, the collateral requirement for the trade could be between $130,000 and $395,000. Given the margins of most wind energy projects, requiring additional collateral for these transactions under the Dodd-Frank Act would likely jeopardize the further deployment of renewable energy.

Allowances and Offsets are prevalent in emissions markets such as carbon markets and markets for SO_2 and NOx under the Clean Air Act. In these markets, Allowances are created and distributed by the U.S. Environmental Protection Agency (EPA) and state government entities. Emissions Allowances are transferred between counterparties, often through forward contracts, with the purchasing party obtaining the ability to use the allowances for compliance with clean air or greenhouse gas regulations. The forward sale of Allowances and Offsets allows market participants to hedge the compliance obligations associated with expected emissions.

III. Conclusion of the Interagency Working Group

The Interagency Working Group for the Study on Oversight of Carbon Markets was tasked under Section 750 of Dodd-Frank Act ("Interagency Working Group") with conducting a report on the regulation of carbon markets. The Interagency Working Group published its Report on the Oversight of Existing and Prospective Carbon Markets, on January 18, 2011 ("Section 750 Study").[6]

The Interagency Working Group concluded that since Allowances and Offsets were commodities, the CFTC had broad enforcement authority to pursue price manipulation actions against carbon market participants.[7] It also concluded that "absent specific action by Congress, neither the CFTC nor any other federal agency may have any authority to routinely monitor trading in the secondary markets or to create rules or regulations that would apply to these

[6] *See* Interagency Working Group for the Study on Oversight of Carbon Markets, "Report on the Oversight of Existing and Prospective Carbon Markets", January 18, 2011. Available at: http://cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_carbon_011811.pdf.

[7] Section 750 Study at 43.

markets."[8] Although, "with respect to the carbon derivatives market, to a large extent, once the provisions of the Dodd-Frank Act become effective … comprehensive oversight of carbon derivative products, whether traded on an exchange or OTC, will be achieved. However, primary and secondary carbon allowance and offset markets will not be subject to the same comprehensive oversight as derivative markets."[9]

The authority over swaps markets for Environmental Commodities granted under Title VII of the Dodd-Frank Act is in addition to the Commission's existing authority over certain derivatives on Environmental Commodities. For example, futures contracts for SO_2 and NOx Allowances and certain carbon Allowances are traded on designated contract markets (DCMs). The Chicago Climate Futures Exchange also lists several REC futures contracts. The CFTC already has regulatory oversight over these DCMs and the futures listed on these exchanges.

AWEA does not contest the conclusion of the Interagency Working Group that Environmental Commodities are commodities for the purpose of the CEA and that the primary and secondary markets for Environmental Commodities are subject to limited CFTC jurisdiction. We also agree that derivatives transactions with regards to Environmental Commodities that would fall under the definition of "swap" would be subject to CFTC regulation under Title VII of the Dodd-Frank Act. However, AWEA believes that physically-settled forward transactions in Environmental Commodities are not "swaps."

IV. Forward Transactions on Environmental Commodities Are Not Swaps

Environmental Commodities are "nonfinancial commodities," the spot or forward delivery of which is "physically settled" and, therefore are within the exclusion from the definition of "swap" in Section 1a(47)(B)(ii) of the CEA. In other words, physically settling forward transactions in Environmental Commodities should be excluded from the definition of "swap" because they are a transaction for a "nonfinancial commodity or security for deferred shipment or delivery" that is "intended to be physically settled."[10]

A. Environmental Commodities are Non-Financial Commodities

An Environmental Commodity is intangible; it cannot be held. Environmental Commodities are collection of rights and obligations related to compliance with environmental regulations or voluntary environmental standards that exist in certificate form or on registries. This intangibility can be mistakenly used to categorize environmental instruments as financial products. However, Environmental Commodities should be considered physical "nonfinancial commodities."[11]

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[8] *Id.*

[9] *Id.* at 51.

[10] *See* Section 1a(47)(B)(ii) of the CEA.

[11] In its Notice of Proposed Rule Making on "Adaptation of Regulations to Incorporate Swaps", 76 Fed. Reg. 33,066 (Jun. 7, 2011), the CFTC's requests comment on its proposed the definition of "physical." *Id.* at 33,069. AWEA

Market participants physically deliver Environmental Commodities for a purpose other than the exchange of funds. As is the case with other physical non-financial commodities, when a transaction for Environmental Commodities is closed out, one party delivers something that can be consumed. Whether consumption is compliance with an RPS or laws limiting emissions of greenhouse gases, Environmental Commodities are delivered and used to satisfy an end that cash cannot. In the case of Allowances, they represent an authorization to emit as a means of regulatory compliance. With respect to RECs, they constitute proof of a beneficial activity. As for Allowances and Offsets, they represent activity allowing or reducing greenhouse gas emissions.

B. Transactions in Environmental Commodities are Physically Settled

The term "physical settlement" is commonly used in the commodity trading industry to refer to cases where the forward sale of a commodity is satisfied through means other than a cash payment; in other words, a contract that results in actual delivery of the commodity. Actual delivery occurs when the legal title to an item, physical or intangible, passes from one party to the other. Moreover, the term physical settlement is often used to refer to actual delivery in forward contracts concerning intangible commodities (*e.g.,* foreign currency). Nothing in the language of the Dodd-Frank Act suggests that Congress intended anything other than this common usage of physical settlement in crafting the exclusion from swaps for forward contracts. Thus, a transaction that results in actual delivery of Environmental Commodities should be regarded as "physically settled" within the meaning of Section 1a(47)(B)(ii) of the Commodity Exchange Act.

When trading Environmental Commodities in the spot or forward markets, physical settlement is typically accomplished either by physical delivery via a registry or other tracking system. In both circumstances cash is paid by one party and rights and obligations other than money are delivered to the other. For example, for RECs, the PJMEIS Generation Attribute Tracking System's electronic registry records a change of owners or a physical transfer of paper attestations occurs. For Allowances and Offsets, a physical transfer of title pursuant to a contract or attestation sometimes occurs, but usually there is also an electronic transfer of ownership on the applicable registry, such as those maintained by the Climate Action Reserve, the Verified Carbon Standard or the American Carbon Registry. These result in actual physical delivery of the Environmental Commodities into these centralized databases. The Environmental Commodities are then eventually consumed through retirement for compliance or voluntary stewardship.

A helpful analogy to use for the physical settlement of transactions in Environmental Commodities is the physical settlement of securities transactions. Like with the sale of an Environmental Commodity, the sale of a security transfers the rights and obligations

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respectfully recommends that the CFTC adopt a definition of "physical" that is consistent with the arguments set forth above.

associated with the security. The sale of a security can be accomplished by the physical delivery of the security, if it is certificated, or through a book entry transfer in the relevant registry. Congress acknowledged the similarity between the transfer of securities and certain non-financial commodities. Section 1a(47)(B)(ii) of the CEA excludes sales of both non-financial commodities and securities for deferred shipment or delivery from the definition of “swap,” so long as the transaction is intended to be physically settled. As such, AWEA respectfully requests that the CFTC treat physically settled forward transactions on Environmental Commodities consistent with Congressional intent and exclude them from definition of “swap.”

V. Conclusion

For the reasons set forth above, we respectfully request that the CFTC find that Environmental Commodities are not swaps and qualify for the forward contract exclusion from the swap definition.

Sincerely,

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