CE2 Carbon Capital

July 22, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
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Submitted via Regulations.gov

Re: Comments on Regulation of Environmental Commodities and Further Definition of "Swap" in Proposed Rules Under The Dodd-Frank Wall Street Reform and Consumer Protection Act

File Number S7-16-11

To Whom It May Concern:

CE2 Carbon Capital, LLC is pleased to submit these comments in response to the Commodity Futures Trading Commission's ("CFTC") and Securities and Exchange Commission's ("SEC") joint proposed rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") regarding "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping" ("JNOPR").[1] These comments address Question 32 of the JNOPR, relating to environmental commodities.

Question 32 asks:

> "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?"[2]

We briefly address each question in turn. Since we are aware of separate comments being submitted by trade associations that focus on the legal interpretation of relevant terms, our

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

[2] *Id.* at 29,832.

comments will focus on describing environmental commodity markets and the physical settlement of forward trades in these products. At this time, CE2 Carbon Capital, LLC takes no position on the remainder of the JNOPR.

In summary, environmental commodities are capable of being physically settled, despite their intangible nature. Forward transactions of environmental commodities that are intended to be physically settled should fall under the forward contract exclusion of the Commodity Exchange Act ("CEA"), and should not be regulated as "swaps." Physically settled environmental commodities should be regulated like other physically settled commodities; and financially settled environmental commodities should be treated like other financially settled commodities. No distinction is warranted based on the intangible nature of these products.

I. About CE2 Carbon Capital, LLC

Formed in 2008 by CE2 Capital Partners and Energy Capital Partners, CE2 Carbon Capital, LLC ("CE2") is a company dedicated to building a portfolio of carbon offsets and other assets focused on reducing greenhouse gas ("GHG") emissions in North America. CE2 invests in and develops carbon emission reduction projects and enters into long-term forward purchase agreements of environmental commodities from carbon emission reduction and renewable energy projects.

II. Description of Environmental Commodity Markets

As noted above, CE2's core business is the creation and transaction of environmental commodities. We are active in and very familiar with the trading of renewable energy certificates ("RECs"), GHG emission reduction credits, GHG allowances, and other types of environmental commodities. Compared to other commodities, these markets to date have been small and fragmented. They are largely creations of legislatures or government agencies, or begin in anticipation of such laws and regulations and therefore are largely dependent upon government action for their existence.

The most active markets, which still pale in comparison in terms of size and liquidity to other commodity markets, are in those products that have already been created by a regulator. In the United States, that includes the sulfur dioxide and nitrogen oxide emission allowance markets, created by Congress in the 1990 Clean Air Act Amendments, carbon dioxide allowances for use in compliance with the Regional Greenhouse Gas Initiative, initiated by the governors of ten northeastern states, and RECs that are used for compliance with nearly thirty different state legislature-created renewable energy portfolio standards. In addition, with California's pending adoption of a greenhouse gas emissions trading program under the legislative A.B. 32 framework, forward trades of both California allowance and compliance-grade offset credits are beginning to take place.

Compliance and Voluntary Markets

The trading of products like sulfur dioxide, nitrogen oxide and GHG emission allowances, and state-issued RECs, is known as the "compliance market" since those products were created by a government agency or legislature and exist solely to demonstrate compliance with a regulatory requirement. Entities facing compliance obligations are required to submit these products to a government body to demonstrate they have complied with renewable energy and emission reduction requirements under law.

A "voluntary market" also exists for some of these products. The voluntary market exists to anticipate future laws and regulations, helping companies to hedge against the risk of future compliance programs. A segment of the voluntary market also trades for corporate social responsibility and environmental reasons. For instance, if a company wishes to make its operations "carbon neutral," it often will purchase voluntary, verified GHG emission reduction offset credits.

Typical Transactions

RECs

A typical REC transaction plays out as follows. The owner of a photovoltaic solar project in a state that has a renewable portfolio standard will be issued a REC for each megawatt hour (MWh) of power that the solar project generates. RECs reflect the environmental attributes or "solarness" of the power that the solar project generates and are verified in conjunction with meters or other mechanisms by which the power is measured. The project owner thus can sell both power (as "brown" power) and RECs as separate commodities. In fact, the majority of states with REC trading programs explicitly unbundle the RECs and the power and require them to be sold as individual commodities.

In advance of construction, the project developer will often seek to enter into a long-term (i.e., 5-20 years) agreement with a purchaser of the solar project's RECs. The purchaser in this forward agreement agrees in advance to purchase all the RECs that are generated by the project for an agreed-upon price per REC. Like a power purchase agreement, a long-term REC purchase agreement provides certainty to the project owner and its lenders that the project will generate revenue over a large portion of the project's lifetime. In these transactions, payment typically is not made until the RECs are delivered each month or quarter, but the certainty of future, regular payments from a creditworthy purchaser (whether it be an "end-user" utility or an intermediary like CE2) is enough for many lenders to agree to lend the project the capital to purchase and install expensive solar equipment.

Every month after the power has been generated, RECs will be deposited into the project owner's electronic registry account. (REC registries or "tracking systems" are usually operated by a sister entity of the relevant regional independent system operator.) The project owner will then transfer the RECs into the purchaser's registry account. Transfer involves the seller logging into its registry account and submitting a transfer request with the registry to transfer a certain number of RECs to an identified recipient registry account. Depending on the requirements of the registry, the recipient may or may not have to affirmatively accept the receipt of the RECs into its account. Title and risk of loss for those RECs typically transfers upon delivery of the

RECs to the purchaser. Payment for the RECs will then be made within an agreed upon number of business days.

Carbon

Carbon transactions operate in a similar fashion. In the U.S., carbon products can be classified into two broad categories: allowances and offset credits. GHG allowances are created and issued exclusively by government bodies. They represent one ton of greenhouse gas, in units of "carbon dioxide equivalent," and authorize a compliance entity to emit. At the end of a year, under a typical cap-and-trade program, a compliance entity is required to submit allowances for every ton of greenhouse gases that it has emitted. If it fails to do so, it is subject to penalties. The sulfur dioxide and nitrogen oxide allowance programs under the Clean Air Act also operate in this general manner. The creation, distribution (whether by auction or free allocation), ownership and transfer of allowances all takes place on electronic registries operated either by government entities or their private contractors.

The other type of GHG-related transaction is the creation and trading of GHG emission reduction offset credits. Offset credits are created when an entity that is not subject to a compliance obligation under a GHG regulation reduces its emissions voluntarily. A common example of a GHG offset project is the destruction of the potent greenhouse gas methane from landfills by flaring it or using it in a turbine to generate electricity. By the use of well-established protocols or methodologies, it is easy to determine how many tons of methane have been prevented from escaping to the atmosphere by the installation and operation of that flare or turbine. Each ton destroyed is additional to what would have occurred in the absence of that project. Those GHG emission reductions therefore have value because they may be eligible for compliance under a future GHG cap-and-trade regime that may allow offsets to be used instead of allowances.

There are several organizations and programs that sponsor protocols, methodologies and registries under which these GHG reductions can be verified by third parties and electronically issued, including the Climate Action Reserve, the Verified Carbon Standard Association and the American Carbon Registry. Once issued, these tons are generically known as "verified" or "voluntary emission reductions" ("VERs") or simply "offsets," though each organization also has specific terms for their unique brand of VER, including "climate reserve tonne," "verified carbon unit," and "emission reduction ton." Each represent a verified form of voluntary emission reduction equal to one ton of carbon dioxide-equivalent. Each of these voluntary registries also allows for the physical transfer of VERs between two parties.

The terms "primary" and "secondary" are often applied to carbon offset credits. Primary VERs or offsets refer to their creation and initial issuance from a project. Secondary VERs or offsets refer to the credits once they have been issued and are easily transferable. Secondary credits tend to trade at a premium to primary ones, all other things being equal, because primary units carry project, issuance, credit and greater change in law risk. Once the credits have been issued, they carry fewer of these risks, and buyers are willing to pay a higher price for the greater certainty of an issued credit.

Carbon offsets in some respects are difficult to classify as *commodities* since they are not yet truly fungible. VERs will garner different prices depending on what type of project has generated them, where in the world or U.S. they have been generated, and when they were generated. Once there is greater certainty about what types of offsets will be accepted for compliance purposes in a regulatory regime and they become more fungible, prices for compliance-grade offsets will likely converge.

III. Physical Settlement of Environmental Commodity Transactions

Most, if not all, environmental commodities exist in the U.S. as intangible products evidenced on an electronic registry. These products are intangible in the sense that you cannot hold them in your hands like cotton, corn or other commodities. However, like electricity, transactions in environmental commodities can be physically settled. Ownership changes hands on a date certain, and payment occurs upon delivery.

Over-the-counter forward contracts for RECs and carbon products are called "purchase and sale agreements" or simply "purchase agreements." While their creation and existence is different from a tangible object that is bought and sold and trades hands, a purchase agreement for a REC looks very similar to a purchase agreement for any other type of product that might be delivered, like sugar or furniture. The parties agree on a price for the product, a delivery date by which that product must be delivered, a location to which that product must be delivered, and a date by which payment for that product must be made. The agreement will contain representations and warranties, a liquidated damages provision for a failure to deliver or accept the product, and an indemnity provision. Most forward physically settled environmental commodity transactions trade by bespoke agreement. Like any tangible product that is bought and sold, the terms of the transaction can be customized and may vary significantly. However, despite the intangible nature of the product, physical delivery of the product on an electronic registry does indeed occur, and title to that product transfers upon delivery (or sometimes upon payment).

To be sure, environmental commodities can also be transacted on exchanges and be cash-settled. Derivatives of environmental commodities exist. Those transactions are usually very different from physically settled REC and carbon transactions. They utilize very different contract terms and are undertaken for different purposes. CE2 believes that these types of trades—those that are not intended to be physically-settled—should be regulated like other commodities that are cash-settled. Among the world of cash-settled transactions, there is no reason to treat cash-settled environmental commodities differently than other cash-settled products.

IV. 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?

Because we believe that forward transactions in environmental commodities that are intended to be physically settled should be treated like forward transactions in other commodities that are intended to be physically settled, we do not believe that applying the forward contract exclusion

of the Commodity Exchange Act[3] to this class of products would run afoul of the intent of the Dodd-Frank Act. Forward contracts for environmental commodities should not be subject to the swap regulatory regime envisioned by the Dodd-Frank Act.

V. Conclusion

Due to the unique characteristics of environmental commodities, and the fact that they are physically settled, CE2 believes it would be a mistake for the CFTC to regulate forward transactions in the physical portion of these markets as "swaps." Doing so would be like fitting a square peg into a round hole. Forward transactions of environmental commodities that are intended to be physically settled should fall under the forward contract exclusion.

We would be happy to provide additional detail with regard to how these markets work and how regulation of the physically settled environmental commodities as "swaps" would be detrimental to the market. Please do not hesitate to contact either of us at 858-481-0024 if you would like to discuss these comments.

Sincerely,

Harold Buchanan
Chief Executive Officer

Gregory Arnold
President

[3] CEA Section 1a47(B)(ii).