

## LEGISLATIVE DEVELOPMENTS

### PROTECTING AGAINST SUBPRIME CARBON: PROPOSED FRAMEWORK FOR REGULATION OF CARBON MARKETS IN THE AMERICAN CLEAN ENERGY AND SECURITY ACT OF 2009

In crafting the American Clean Energy and Security Act of 2009 (commonly referred to as the ACESA or the Waxman-Markey bill), congressional leaders carefully managed language creating and regulating a market for carbon allowances, offsets, and carbon derivatives. On the day the ACESA went before the entire U.S. House of Representatives for a vote, an amendment including significant regulation of carbon derivatives was inserted into the bill. While it is likely that few legislators read the amendment, the wording appears focused on curtailing abuses. The proposal takes lessons learned from the Enron disintegration as well as the current fiscal crisis to provide overlapping regulatory oversight and eliminate some loopholes that allowed for manipulation of markets in the past. The expectation is that a market based on reducing greenhouse gases can operate effectively and efficiently and avoid undue volatility.

The ACESA, passed by the House of Representatives on June 26, 2009, establishes a federal cap and trade system and provides a framework for regulation of the carbon market as part of its comprehensive national climate and energy legislation. The proposed legislation gives the Federal Energy Regulatory Commission (FERC) regulatory authority over the cash market for emission allowances, compensatory allowances, offset credits and federal renewable electricity credits established or issued under the ACESA, and gives the Commodity Futures Trading Commission (CFTC) regulatory authority for derivatives based on allowances or credits established or issued under the ACESA. The ACESA prohibits "over-the-counter" (OTC) trading of carbon market derivatives and also provides for significantly greater regulation of traditional energy-related derivatives.

#### Use of Derivatives in Cap and Trade Markets

A derivative is a financial instrument whose value is based on the value of an underlying reference: an asset such as a commodity, bond, equity or currency,

or an index of such assets, or an event. Derivatives are typically used by operating businesses for risk management related to volatility of costs and prices. On the other side of the transaction, a counterparty assumes the risk in exchange for a return on investment. It is likely derivatives will be used extensively in connection with any federal cap and trade carbon market. Emitters subject to any cap and trade program with concerns about volatility in the cost of emissions allowances will likely hedge the price risk of carbon allowances several years ahead through the use of derivatives. Unlike allowance trading, trading in carbon derivatives will not be constrained by the volume of allowances available in the market because derivatives trade on promises to deliver allowances at a later date rather than the actual exchange of an allowance.

#### Broader Regulation of Derivatives Sought Independent of Cap and Trade Market

Although the CFTC regulates commodities, futures contracts, and certain types of derivatives, most OTC derivatives in today's market are unregulated. OTC derivatives are derivative contracts between businesses and counterparties that are not traded on an exchange or otherwise centrally cleared or reported. There is consequently little market transparency on prices or aggregate trade volumes. Likewise, OTC parties are not generally subject to capital and margin requirements and business conduct standards. For example, OTC parties can easily evade the limits on the size of speculative positions, which are key anti-manipulation features of regulated futures exchanges. OTC energy derivatives have been generally excluded from regulation by CFTC as long as they are entered into between parties that are "eligible contract participants," which include banks, financial institutions and significant businesses. This exemption of OTC energy derivatives trades is commonly referred to as the "Enron loophole."

A broad consensus is building among U.S. regulatory authorities on the need for comprehensive regulatory reform for derivatives, particularly OTC derivatives. When energy prices reached record highs in 2008, there was concern financial speculation was driving prices beyond levels justified by supply and demand. Widespread use of credit default swap derivatives by AIG and others has been blamed in part for the credit crisis. The White House issued a policy paper on proposed derivatives reform on June 17, 2009. On June 22, 2009, Securities and Exchange Commission Chairman Mary Schapiro testified on regulation of OTC derivatives before a subcommittee of the U.S. Senate Committee on Banking, Housing and Urban Affairs. In the ramp-up to the vote on Waxman-Markey in the House, advocacy groups including Friends of the Earth used concerns about potential carbon offset derivative issues to warn against "subprime carbon." At the time of adoption of the ACESA, there were six stand-alone proposals for general OTC derivatives reform legislation in Congress. Provisions from several of these stand-alone proposals were included in the Waxman-Markey bill before its adoption by the House.

The provisions of the Waxman-Markey bill related to cap and trade market regulation, and broader derivative reform did not receive significant attention prior to passage. The Waxman-Markey bill as reported out of the Energy and Commerce Committee on May 21, 2009, for discussion, and further amended by a substitute amendment filed on June 22, 2009, was also modified in a number of respects by the manager's amendment submitted on the same day of the passage by the House. This manager's amendment included aspects of the regulation of the carbon derivatives market highlighted below.

### Carbon Market and Energy Derivative Regulation in the ACESA

The ACESA provides for the FERC to regulate the cash market in emission allowances and offsets created under title VIII of the ACESA. FERC is to promulgate regulations for the establishment, operation and oversight of the markets for regulated allowances. The regulations are to be designed to prohibit fraud, market manipulation and excess speculation, and to provide measures to limit unreasonable allowance price fluctuation. FERC would also prescribe regulations to establish position or transaction limitations

for each class of regulated allowance, and establish standards for qualification and operation of both trading facilities for regulated allowances and clearing organizations for these trading facilities. FERC will have the authority to suspend or revoke the registration of any trading entity in violation of any rule or order. The regulations are due 18 months from enactment.

The Waxman-Markey bill as reported out of the Energy and Commerce Committee called for the President to delegate to appropriate agencies the authority to promulgate regulations for the establishment, operation, and oversight of all markets for regulated allowance derivatives. However, the ACESA as amended by the manager's amendment and adopted by the House gives the CFTC regulatory authority for derivatives based on allowances and credits established or issued under the ACESA and expressly prohibits OTC trading in regulated allowance derivatives. The ACESA also makes it a federal crime to commit fraud or manipulate any carbon market, and provides for regulations to facilitate and maintain market oversight and transparency and require market monitoring to prevent fraud, manipulation and excessive speculation.

The ACESA expands CFTC regulation of OTC derivatives in energy commodities and energy-related commodities by eliminating the previous exemption for energy derivatives, and thereby closing the Enron Loophole. The new term "energy commodity" includes coal, crude oil, gasoline, diesel fuel, jet fuel, heating oil, propane, natural gas, and electricity (excluding financial transmission rights, which are subject to regulation and oversight by the FERC) and leaves open the possibility that other sources of energy may be included as well. The ACESA significantly narrows but does not fully eliminate the current OTC market in energy derivatives. The provisions of the ACESA do not expressly require that all derivatives in energy commodities be traded "on-exchange," but mandates the central clearing of derivatives in energy commodities unless a waiver is obtained.

The ACESA non-carbon market derivatives regulation is intended as placeholder legislation. The substantive provisions of the ACESA regarding regulation of energy derivatives will be repealed, and related regulations will be null and void upon passage of legislation that includes derivative regulatory reform.

The ACESA will next be sent to the U.S. Senate for consideration. The Senate Energy and Natural Resources Committee has already passed on a bill entitled the American Clean Energy Leadership Act that addresses several energy issues, including many addressed under the ACESA. The Senate Environment and Public Works Committee is also considering its own greenhouse gas cap and trade measure. These measures, as well as measures passed by some other Senate committees, will likely be combined to create the Senate counterpart of the ACESA. If the Senate passes its own version of an energy bill, differences between the Senate and House bills will have to be reconciled, with the final bill passed by both houses of Congress, before the bill can be sent to President Obama for signature into law.

### Conclusion and Implications

Whether or not the specific cap and trade system

and related regulation in the ACESA becomes final law, any cap and trade system will create significant new markets for carbon allowances and carbon derivative products. Independent of the proposed development of a federal cap and trade system in the U.S., there is increased support for greater regulation of derivatives driven by both the credit crisis and concerns regarding manipulation and speculation in the energy markets. The ACESA as adopted by the House of Representatives is an important indication of one likely approach to the regulation of the trade portion of a cap and trade program. The regulation of carbon derivatives will also be either influenced by, or directly regulated by, broader derivatives regulation. Transparency and accountability in the carbon market will be important both to the stability of financial markets and the effectiveness of the cap and trade model to reduce carbon emissions. (N. Chafin/B. Flanagan)

## HOUSE APPROVAL OF HR 2454 LEAVES UNANSWERED QUESTIONS REGARDING COAL'S PLACE IN A LOW CARBON ECONOMY

On June 26, 2009, the U.S. House of Representatives narrowly passed the American Clean Energy and Security Act of 2009 (HR 2454 or ACESA) by a 219-to-212 vote. One of the most significant questions about the bill is what HR 2454 ultimately will mean for the U.S. coal industry. Today, approximately 49 percent of American energy is derived from coal. Some argue that HR 2454, as amended and passed, will reduce this percentage significantly, as natural gas and other less carbon-intensive fuels begin to supply more of the nation's energy. Others, however, argue HR 2454 will increase coal usage, as a result of the opportunity for coal users to purchase offsets in lieu of reducing emissions.

This ongoing debate has highlighted a number of factors in the legislation that may have an impact on how the industry will evolve over the next several years. Factors that have attracted the most attention from stakeholders in the wake of HR 2454 are allowance allocations, offsets, research and development of advanced technologies, and performance standards for newly permitted coal-fired power plants.

### Allowance Allocations and Offsets under the Proposed Cap-and-Trade System

HR 2454 creates a complex cap-and-trade system under which GHG allowances would be made available to, and bought and sold by, sources in a regulated credit market. Generally, cap-and-trade systems are designed to require polluters to internalize the external costs of polluting by putting a market price on emissions. In theory, such internalization alters economic efficiency calculations and behavior. In practice, however, the pricing of credits is often influenced by a variety of factors, thwarting the intended impact of these market mechanisms.

Under the House-approved cap-and-trade system, coal users will be looking to two different, but related, market conditions: allowance allocations and offsets.

### Allowance Allocations

Unlike the cap-and-trade system originally envisioned by President Obama, which would have auctioned all allowances with the proceeds going to the