



## **CFTC Chicago Climate Exchange Inquiry May Preview CO2 Market Rules**

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The Commodity Futures Trading Commission (CFTC) has taken first steps toward possibly regulating carbon credits traded on the voluntary Chicago Climate Exchange, a development that utility industry and other stakeholders are closely watching because it could portend how the commission would regulate carbon trading if Congress enacts a mandatory cap-and-trade program.

On Aug. 14, the CFTC issued a Notice of Intent to determine whether the Carbon Financial Instrument (CFI) traded on the Chicago Climate Exchange performs a price discovery function. The CFI represents 1,000 metric tons of CO2 equivalent. If the CFTC decides the instrument does serve as a price discovery mechanism, then CFIs traded on the exchange, and market participants, would be subject to CFTC regulations, such as the commission's large trader reporting requirements and position limits.

CFTC published the Notice in the Aug. 20 Federal Register and made it available for comment for 15 days.

The Chicago Climate Exchange, a voluntary but legally binding cap-and-trade program, welcomed the decision, saying it "reflects the increasing maturity of the carbon market," according to a spokesperson.

This would be the second time the CFTC has exercised this authority, granted in the 2008 Farm Bill. The authority allows the CFTC to determine whether a contract traded on an unregulated exchange can influence the price of a contract traded on a regulated exchange. The first time CFTC used this authority, last month, it found that natural gas contracts traded on the unregulated Intercontinental Exchange (ICE) served a price discovery function, impacting similar contracts on regulated exchanges.

An official with the Carbon Markets and Investors Assn. (CMIA) -- which represents financial institutions, funds, and others who provide services to entities subject to mandatory emissions reduction programs -- says the CFTC step could be "indicative of the attitude of the CFTC" toward a larger, mandatory carbon market that might be enacted in the United States.

The climate bill passed by the House earlier this summer gives FERC authority over a carbon allowance market but gives the CFTC authority over any carbon derivative markets.

The CMIA official says the organization supports CFTC regulations that bring more transparency to the markets, such as disclosure of who is trading and in what volumes. Furthermore, position limits set by the CFTC could limit the volatility of the market and the effects of speculation, the official says.

But position limits, combined with congressional proposals to ban over-the-counter (OTC) derivative trading, could prove to be problematic and increase the compliance costs for major emitters like utilities, which could then pass those extra costs onto the consumers, the official says.

The utility industry, which regularly uses OTC derivative markets to hedge fuel and power costs, is closely watching market regulation developments and has strongly opposed legislation that would ban OTC derivative markets. Utilities argue that exchange collateral requirements would tie up cash needed for other purposes. Furthermore, utility sources argue, OTC markets provide for more flexibility and customization than exchanges.

The CMIA official explains that the prohibition of OTC derivative markets will push swaths of carbon transactions onto the regulated exchanges. That result, combined with position limits in an exchange, could squeeze the utilities' ability to manage the risk of fluctuating carbon prices because their positions could approach the CFTC limits.

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