

Developments in United States and International Regulation of Greenhouse Gas Emissions and Markets

This past year saw much activity in the United States on the climate change front, including developments in Greenhouse Gas (“GHG”)¹ emissions and related commodity and derivatives trading regulation. This paper discusses what these regulatory developments, as well as the various legislative initiatives, may mean for domestic carbon markets. We also provide a brief overview of the Copenhagen Climate Summit, and its implications. We conclude with a review of the regulation of existing carbon markets and what we can expect in 2010.

I. Background

Climate change legislation, in addition to health care and financial regulation reform, is one of the three main legislative priorities of the Obama administration. On all three of these fronts, 2009 was an exceptionally busy year. On the climate front, and although the U.S. has never officially ratified the Kyoto Protocol,² (the international emissions reductions scheme), several mandatory and voluntary carbon reduction programs have started in the U.S. on the state or regional level.³ There also are a number of voluntary carbon reduction programs in the U.S. and internationally that are giving rise to a growing market infrastructure (environmental registries, offset project standards, and green exchanges).⁴ And, as the high-level participation of President Obama in the U.N.-sponsored summit in Copenhagen in December, 2009 indicates, there is a commitment on the part of the current U.S. administration to contribute to global efforts to combat climate change.⁵

Although it is not a foregone conclusion that the cap-and-trade legislation will pass in the U.S. in 2010 (there is a growing opposition to the concept of cap-and-trade with an alternative proposal of the carbon tax), it appears that the Obama Administration is posed to use all available administrative tools to accomplish on the agency level what may not be accomplished legislatively in the short-term (discussed below).⁶ Both the Environmental Protection Agency (“EPA”) and the Commodity

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¹GHGs include carbon dioxide (CO₂), methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, and sulphur hexafluoride.

²[Kyoto Protocol to the United Nations Framework Convention on Climate Change, Dec. 10, 1997, 37 I.L.M. 22 \(1998\); UNFCCC, Kyoto Protocol.](#)

³Note the Regional Greenhouse Gas Initiative (RGGI) involving 10 Northeastern and Mid-Atlantic states; the Climate Action Reserve, the Gold Standard and the Voluntary Carbon Standard that set standards for emissions-reduction projects; several state NO_x and SO_x programs; and the pre-compliance market for cap-and-trade to be established in California.

⁴[E.g., Chicago Climate Exchange.](#)

⁵[United Nations, Climate Change Conference.](#)

⁶S.J. Res. 26, 111th Cong. (2010) (joint resolution sponsored by Senator Lisa Murkowski (R-AK), introduced on January 21, 2010, disapproving of EPA’s recent endangerment and cause or contribute findings regarding GHGs). Sen. Murkowski’s resolution, if adopted by the Senate and the House, and signed by the President, would act as a veto of EPA’s findings. We believe that it is very unlikely that the president will sign this proposed legislation.

Futures Trading Commission (“*CFTC*”), as the agencies charged respectively with the “cap” and “trade” components, have expressed their readiness to stand to this challenge.⁷

II. Legislative Developments in the United States

For the first time ever, the U.S. House of Representatives (“*the House*”) passed a climate change bill that would mandate a cap and trade program for GHG emissions; the Senate has also proposed several important pieces of legislation on climate change that are pending consideration in no fewer than five Senate committees.

In June 2009, the House narrowly passed the Waxman-Markey Bill, also called the American Clean Energy and Security Act of 2009 (“*Waxman-Markey Bill*”).⁸ The Waxman-Markey Bill would impose a cap on GHG emissions and require covered entities to obtain emission allowances for their GHG emissions. GHG reduction targets are set in the bill at 17% below 2005 levels by 2020 and 83% below 2005 levels by 2050. The emission reduction provisions will apply to “covered entities” such as electric utilities, liquid fuel producers and importers, and other sources that emit more than 25,000 tons of CO₂ a year.⁹ Initially, the majority of allowances will be distributed to “covered entities” for free, but they must be used to protect consumers from higher energy prices.¹⁰ Under this bill, compliance obligations will begin in April 2013 for electric utilities and fuel producers, and industrial stationary sources must comply beginning April 2015.¹¹

Further, in June 2009, Senators D. Feinstein and O. Snowe introduced the Carbon Market Oversight Act of 2009 bill (“*Feinstein/Snowe Bill*”) that would establish an Office of Carbon Market Oversight within the CFTC and would give the CFTC jurisdiction to oversee U.S. carbon cash and derivatives markets.¹² The Feinstein/Snowe Bill would require the CFTC to enter into a memorandum of understanding with the Federal

Energy Regulatory Commission (“*FERC*”), EPA, and any state or regional GHG emissions reduction program to coordinate oversight of carbon trading facilities, carbon traders, carbon clearing organizations, and derivative clearing organizations. In addition, the Feinstein/Snowe Bill would: (i) require the CFTC to establish a Carbon Clearing Organization for the purpose of creating a common clearing platform for emission allowances; (ii) require the trading of emission allowances to occur through carbon allowance trading facilities registered with the CFTC and be approved by the Carbon Clearing Organization; (iii) require registered carbon trading facilities to conduct real-time electronic monitoring of carbon trading, ensure fair trading, and publicize trading data; (iv) establish professional standards required of registered carbon market brokers, dealers, and traders; and (v) allow limited over-the-counter or bilateral trading. While the Feinstein bill gained little traction, it remains a point of reference with regard to a potential regulatory oversight structure for a future compliance carbon market.

In the summer and fall of 2009, the Senate focused its attention on S. 1733, the Clean Energy Jobs and American Power Act (“*Kerry-Boxer Bill*”).¹³ The bill was introduced by Senator John Kerry (D-MA) and Senator Barbara Boxer (D-CA), Chairman of the Senate Environment and Public Works Committee (EPW). Largely mirroring its House-passed counterpart (with the exception that it sought a more aggressive emission reduction target of 20%), the legislation was met with skepticism from the start. The Senate leaders on climate change face a greater political challenge than their counterparts in the House in harmonizing their geographical, agricultural, and industrial interests. With the U.N. Climate Conference looming, Senator Boxer, Chairman of the Senate Environment and Public Works Committee (“*EPW*”), pushed for consideration of the bill with only minor modifications

⁷Lisa P. Jackson, *Seven Priorities for EPA's Future*, Jan. 12, 2010 (the first of EPA's seven priorities in 2010 is to take action on climate change through supporting climate legislation as well as enacting regulations under the existing Clean Air Act); Remarks of Chairman Gary Gensler, *CFTC's Role in Cap-and-Trade*, IETA 2009 Fall Symposium, Nov. 3, 2009, available at [\(noting the CFTC's experience in the “trade” part of “cap-and-trade”\)](#); Sarah N. Lynch, *Update: Gensler: CFTC Should Be Agency To Police Carbon Markets*, Nasdaq.com, Oct. 27, 2009 (discussing CFTC's preparedness to regulate emerging carbon market).

⁸H.R. 2454, 111th Cong. (2009).

⁹H.R. 2454 § 311.

¹⁰H.R. 2454 § 321.

¹¹H.R. 2454 § 311.

¹²S. 1399, 111th Cong. (2009).

¹³S. 1733, 111th Cong. (2009).

—against the protest of the entire Republican caucus and at least a couple of Democrats. In the end, the EPW reported out a bill on a party line vote of 11-1.¹⁴ Since this bill has little support going forward, other Senate leaders have been freed to draft compromise language of their own.¹⁵

In November 2009, S. 2729, the Clean Energy Partnerships Act,¹⁶ was introduced by Senator Stabenow (D-MI) and sponsored by a large group of centrist Democrats. It is focused primarily on the “offsets” title of the carbon market legislation. Specifically, it prescribes in greater detail what an acceptable offsets and early action offsets program will look like, and it clarifies the authority of the EPA to approve carbon credits from various sources. The legislation is friendly to manufacturers and agricultural interests by ensuring greater capacity to mitigate the cost of regulation. This bill does not provide detailed market oversight language; presumably, that will be supplied at a later date.

Finally, in early December 2009 on the eve of the Copenhagen Conference, Senators Kerry (D-MA), Lieberman (I-CT), and Graham (R-SC) released a new, “tri-partisan” legislative proposal titled “Framework for Climate Action and Energy Independence in the U.S. Senate.”¹⁷ It takes a substantial step back from the Kerry-Boxer bill by putting aside detail for the sake of outlining concepts that the tri-partisan team believes can garner 60 votes to pass the Senate in 2010. With respect to regulating the carbon market, it calls for “vigilant carbon market oversight, real-time transparency, adequate settlement requirements to control risk in the market and strong quality controls to ensure maximum effectiveness and clarity...provisions to ensure openness and accountability within the carbon market.”¹⁸ Distinct from prior proposals, the framework document provides for additional offshore drilling and nuclear power.¹⁹ These additions are seen

as key to garnering support from certain moderate Republicans. Senator Kerry used this document to indicate U. S. progress on climate change at the U.N. treaty negotiations in Copenhagen, and to demonstrate that the Senate is taking seriously its responsibility to produce workable legislation that is capable of becoming law in 2010.

While “all bets are off” with respect to the ultimate success of climate legislation in 2010, the administration has made clear that President Obama considers the Copenhagen Accord, discussed below, to be a politically-binding agreement, and that he wants to be in a position to negotiate a legally binding agreement with the rest of the world leaders in Cancun, Mexico at the end of this year.

III. Cap and Trade After Copenhagen

In December 2009 the Fifteenth Conference of the Parties (COP-15) to the United Nations Framework Convention on Climate Change (“UNFCCC”) was held in Copenhagen, Denmark to address an agreement to take effect after Kyoto Protocol’s commitment periods expire in 2012.²⁰ At times, the two-week conference appeared on the verge of disintegrating without achieving any tangible results. But, in the eleventh hour, President Obama and Chinese Premier Wen Jiabao struck a deal with India, South Africa, and Brazil regarding monitoring and verification issues that at least allowed a political agreement to be reached on three key issues. Under the resulting Copenhagen Accord, the nations agree: (1) that global temperatures should be allowed to rise no more than two degrees Celsius; (2) that nations, both developing and developed, would publish by January 31, 2010 pledges of planned GHG emissions reductions; and (3) that industrialized nations would provide financial aid to developing nations to help them adapt to climate change.²¹

¹⁴[U.S. Senate Committee on Environment & Public Works, Boxer Statement on Committee Passage of S. 1733—The Clean Energy Jobs and American Power Act, Nov. 5, 2009.](#)

¹⁵[Darren Samuelsohn, With an Eye on Copenhagen, Senate Tiptoes Back into Climate Debate, NY Times, Dec. 1, 2009.](#)

¹⁶S. 2729, 111th Cong. (2009).

¹⁷[Senators John Kerry, Joseph Lieberman & Lindsey Graham, Framework for Climate Action and Energy Independence in the U.S. Senate, Dec. 10, 2009.](#)

¹⁸*Id.* at 4.

¹⁹*Id.* at 2.

²⁰One hundred ninety-two nations signed the UNFCCC, which was formed in 1992 to address the challenges posed by anthropogenic climate change. Although the UNFCCC did not set binding targets for GHG emissions or include any enforcement mechanisms, it has provided a framework for international cooperation on the climate change issue. The first set of binding targets were established in the Kyoto Protocol to the UNFCCC, which was adopted in Kyoto, Japan on December 11, 1997, and entered into force on February 16, 2005. The Kyoto Protocol sets binding targets for industrialized nations to reduce GHG emissions—an average of five percent below 1990 levels by 2012. The United States, although a signatory to the UNFCCC, has never ratified the Kyoto Protocol, citing concerns that developing nations such as China and India were not bound to limit their GHG emissions under the agreement.

²¹[Copenhagen Accord, Dec. 18, 2009.](#)

Although the Accord is non-binding and noticeably void of specifics, it does represent the first time that the leaders of most of the nations of the world appeared in one place to focus on climate change. It is also the first time that China and India have agreed to subject their internal monitoring of GHG emissions to some form of international scrutiny.²² And, while not the amount of money that some developing nations believe is needed or, in their view, warranted given the years of GHG emissions by and related economic growth of industrialized nations, it represents substantial commitments of money to fund adaptation, technology development and transfer and mitigation projects in the developing countries.

Before COP-15, Senator John Kerry announced that he would need a strong political statement in Copenhagen to incentivize the U.S. Senate to pass cap-and-trade legislation in 2010.²³ It is still very much in debate as to whether the Copenhagen Accord is such a statement, although the Obama administration believes the Accord is a politically-binding agreement and has reiterated its intent to push to be in a position to fully negotiate a binding agreement at the next Conference of the Parties (COP 16), currently scheduled for December 2010 in Cancun, Mexico. Without binding promises that China and India will take steps to reduce their GHG emissions, moderate Democrats from manufacturing states may balk at imposing the burdens of climate change legislation on their constituents.²⁴ But the fact that an agreement was reached at all—an agreement that may be built upon at COP-16—has provided proponents of cap-and-trade legislation with hope that an agreement can be reached in the United States as well.²⁵

Former Vice President Al Gore has challenged the U.S. Senate to pass a cap-and-trade bill by April 22—the 40th Anniversary of

Earth Day.²⁶ This is very optimistic, however, as Senate Majority Leader Harry Reid has signaled that he intends to address health care, financial reform, and jobs legislation before addressing climate change.²⁷ And several Democrats have already asked the White House to take cap and trade off the table in 2010.²⁸ As for timing, other Democrats have expressed concern about taking-up a cap-and-trade bill in the summer of an election year, and Senators Kerry, Lieberman, and Graham, in a tri-party pact, are working to get a bill drafted for consideration by the key Senate Committees by March 2010. Thus, while there may be some political momentum coming out of Copenhagen that favors climate change legislation, a host of other political factors may temper the ultimate result. Other options include a more moderate energy bill providing incentives for offshore drilling, nuclear power, and clean coal, or a cap-and-trade bill that covers only certain sources, such as power plants, as opposed to the entire economy.²⁹

IV. Agency Rulemaking

A. EPA Rulemaking Activity

Parallel to the legislative effort, the EPA and the CFTC have been active. EPA has taken several critical steps to pave the way for regulating GHGs using its existing authority under the federal Clean Air Act (“CAA”). In response to the U.S. Supreme Court’s ruling in *Massachusetts v. EPA*,³⁰ the Agency published on December 15, 2009 its final rule concluding that the current and projected concentrations of six GHGs in the atmosphere threaten public health and welfare (the “*Endangerment Finding*”), and that the combined emissions of these GHGs from new motor vehicles contribute to this concentration (the “*Cause-or-Contribute Finding*”).³¹ Although the findings do not impose any new regulatory requirements,³² they require EPA to regulate GHG emissions from new motor vehicles under Section 202(a)

²²Glenn Thrush and Louise Roug, *Climate Deal Falls Short*, Politico, Dec. 18, 2009.

²³Glenn Thrush, *Kerry: COP-15 Needs to Jolt Senate*, Politico, Dec. 16, 2009.

²⁴Lisa Lerer, *Copenhagen Fizzle Won’t Help Bill*, Politico, Dec. 21, 2009.

²⁵*Id.*

²⁶*Id.*

²⁷*Id.*

²⁸Lisa Lerer, *Dems to W.H.: Drop Cap and Trade*, Politico, Dec. 27, 2009.

²⁹Ben Geman, *Senate Climate Change Fight Looks as Tough as Healthcare Reform Bill*, The Hill, Dec. 29, 2009.

³⁰127 S. Ct. 1438 (2007) (holding (1) that EPA has authority to regulate GHGs from new motor vehicles under the CAA, and (2) that EPA must regulate GHGs from new motor vehicles under the CAA unless (a) EPA determines that GHGs do not cause or contribute to climate change, or (b) EPA provides a reasonable explanation as to why it cannot or will not exercise its discretion to determine whether they do).

³¹Endangerment and Cause or Contribute Findings for Greenhouse Gases Under Section 202(a) of the Clean Air Act, 74 Fed. Reg. 66,496 (Dec. 15, 2009).

of the CAA, and they will ultimately support regulation of GHG emissions from stationary sources as well now that EPA has determined that GHGs are “pollutants” subject to CAA authority.³³

In September 2009, a mere six months after publishing its proposal, EPA finalized its proposed rule requiring large stationary sources of GHGs to provide EPA annual reports of their GHG emissions, starting on March 31, 2011 for 2010 GHG emissions.³⁴ The GHG reporting rule requires covered facilities to identify and report total annual emissions of GHGs emitted from all applicable source categories. EPA commented in its proposal that the GHG emissions information generated under the rule would be helpful in developing future climate change policy, including aiding its ability to develop a GHG registry for any future cap and trade program.³⁵ While it is unclear when or possibly even if Congress will pass a cap-and-trade program, EPA has signaled its belief that it may have the authority to design such a program under its existing CAA authority.³⁶

On the heels of EPA’s promulgation of the GHG monitoring rule, President Obama signed on October 5, 2009 an Executive Order on Environmental Sustainability intended to establish an integrated strategy towards sustainability in the federal government and to make reduction of GHG emissions a priority for federal agencies. Of interest to the carbon markets, two elements of the Order are worthy of note: federal agencies are directed to (1) reduce their GHG emissions (OMB is required to establish a federal government-wide target for GHG emissions by 2020), and (2) select vendors and contractors that meet certain environmental sustainability metrics. These directives together will increase demand in the market for offsets, as both the government and its

contractors seek to comply.³⁷

Soon after finalizing its GHG reporting rule, EPA proposed its so-called “**Tailoring Rule**,” which addresses the most obvious difficulty of regulating GHGs, especially carbon dioxide under the CAA.³⁸ The Tailoring Rule would raise the emissions threshold (to 25,000 tons per year) that triggers New Source Review and Title V requirement for stationary sources of GHGs.³⁹ It is widely anticipated that EPA will issue the final Tailoring Rule by March 2010.⁴⁰

B. CFTC and Derivatives Regulation Relating to Emission Markets

With the significant steps taken by EPA, and the substantial interest in Congress in addressing Climate Change, regulation of emissions and carbon credit contracts has also been the focus of attention at the CFTC. Under the Commodity Exchange Act (the “**CEA**”)⁴¹, as amended by the Commodity Futures Modernization Act of 2000⁴² and the Food, Conservation, and Energy Act of 2008 (the “**Farm Bill**”)⁴³, over-the-counter contracts on emissions and carbon credits are exempt from most of the provisions of the CEA. This means, most importantly, that they need not trade on a commodity exchange and need not clear through a registered derivatives clearing organization (“**DCO**”). Contracts on emissions and carbon credits are likely considered to constitute contracts on “exempt” commodities and under Section 2(h)(1) or (3) of the CEA, can be traded either on a bilateral basis or on an exempt commercial market. Furthermore, contracts on emissions and credits that are either “spot” (*i.e.*, for immediate delivery) or “forward” (*i.e.*, for intended physical delivery at some time in the future) are entirely excluded from the CEA.⁴⁴

³²*Id.* at 66,515.

³³[Prevention of Significant Deterioration and Title V Greenhouse Gas Tailoring Rule, 74 Fed. Reg. 55,292, 55,299-300 \(Oct. 27, 2009\) \(to be codified at 40 C.F.R. parts 51, 52, 70, 71\).](#)

³⁴Mandatory Reporting of Greenhouse Gases, 74 Fed. Reg. 56,260 (Oct. 30, 2009) (to be codified at 40 C.F.R. parts 86, 87, 89, 90, 94, 98, 1033, 1039, 1042, 1045, 1048, 1051, 1054, 1065).

³⁵Mandatory Reporting of Greenhouse Gases, 74 Fed. Reg. 16,448, 16,465 (April 10, 2009) (to be codified at 40 C.F.R. Parts 86, 87, 39, *et al.*).

³⁶[For further discussion.](#)

³⁷[For further discussion.](#)

³⁸74 Fed. Reg. 55,292.

³⁹*Id.* at 55,326.

⁴⁰[For further discussion.](#)

⁴¹7 U.S.C. § 1, *et seq.*

⁴²Pub. L. No. 106-554, Appx. E, 114 Stat. 2763 (2000).

⁴³Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 2189 (2008).

⁴⁴Note that although CCX is a spot market exchange, it voluntarily elected to qualify as an exempt commercial market under Sections 2(h)(3)-(7).

The CFTC has on several occasions stated that it is willing and able to assume responsibilities for regulating the futures, OTC derivatives and cash aspects of carbon markets in the U.S. once the cap-and-trade legislative infrastructure is put in place by legislators. As one of its initial steps in the exempt commercial markets, in the summer of 2009 the CFTC issued the Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the CEA and CFTC Rule 36.3(c)(3), to undertake a determination whether the Carbon Financial Instrument Contract offered for trading on the Chicago Climate Exchange, Inc., (“**CCX**”) performs a significant price discovery function.⁴⁵

Chairman G. Gensler has testified several times in front of Congress and has stated that it is crucial to ensure that carbon markets function smoothly, efficiently, and transparently, and that effective regulation of carbon allowance trading will require cooperation on the parts of several regulators. Specifically, he noted that there are six regulatory components of carbon markets that should be considered: (i) standard setting and allocation; (ii) compliance with emissions caps and offset requirements; (iii) recordkeeping and maintaining a registry; (iv) overseeing the trade execution system; (v) overseeing clearing of trades; and (vi) protecting against fraud, manipulation and other abuses.

The first three items of this agenda (*i.e.*, the “cap” components) should be under the EPA’s jurisdiction, while the latter three items (*i.e.*, the “trade” components) should be relegated to the CFTC’s exclusive jurisdiction. The CFTC already oversees trading and clearing of contracts based on emission offset credits, emissions allowances and their associated options and futures on sulfur dioxide, nitrogen oxide, and carbon dioxide allowances and offsets listed on the New York Mercantile Exchange and the Chicago Climate Futures Exchange.⁴⁶

Recognizing that it is important that companies are able to make long-term capital commitments and hedge their long-term price risk of carbon emissions allowances, Chairman Gensler notes that it is critical to get the regulatory oversight right for both the futures markets and the over-the-counter markets that may develop out of a cap-and-trade program.

In December 2009, the U.S. House passed the Derivatives Markets Transparency and Accountability Act of 2009 (the “**House Derivatives Bill**”) that for the first time implemented a comprehensive regulatory framework for regulating OTC derivative contracts.

The House Derivatives Bill includes three important elements of regulatory reform: (i) it requires swap dealers and major swap participants to register and come under comprehensive regulation (this includes capital standards, margin requirements, business conduct standards, and recordkeeping and reporting requirements); (ii) it requires dealers and major swap participants to report and to use transparent trading venues for their swaps as well as provide the CFTC with authority to impose position limits in the OTC derivatives markets; and (iii) it requires that dealers and major swap participants bring their clearable swaps into central clearinghouses.

The House Derivatives Bill includes a very broad definition of a “swap” that will likely include most of the over-the-counter emissions and carbon credit contracts. If that were the case, most of such contracts (if standardized) would be required to be: (i) cleared through a DCO; (ii) traded on an electronic trading system or an exchange; (iii) reportable to a swap repository; and (iv) entered into only between qualified participants who will either be further qualified and will have to register as swap dealers or major swap participants.⁴⁷

Although the House Derivatives Bill attempted to clarify that some of the physical contracts will be excluded from the comprehensive swaps regulation, it remains to be seen whether and how these exclusions will be further defined in the Senate bill that will follow the House Derivatives Bill in early 2010.

In sum, as the cap-and-trade and the voluntary carbon markets will continue to develop in 2010, both the regulatory infrastructure and the business practices will continue to evolve in close cooperation with each other.

⁴⁵Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the Carbon Financial Instrument Contract Offered for Trading on the Chicago Climate Exchange, Inc., Performs a Significant Price Discovery Function, 74 Fed. Reg. 42,052 (Aug. 20, 2009). Note that under the Farm Bill, the CFTC has the authority to designate certain contracts that are traded on exempt commercial markets as “significant price discovery contracts.”

⁴⁶The CFTC has the jurisdiction to regulate currently traded futures and options contracts on emissions and offset credits and also has the jurisdiction to police manipulation in emissions and emissions credits contracts as cash commodities traded in the interstate commerce (Sec. 9(a)(2) of the CEA).

⁴⁷Note that the provisions of the proposed derivatives legislation will apply to the already active OTC emissions and credits markets in the US and overseas. For example, many OTC emissions transactions are documented under the ISDA Master Agreements executed between the counterparties and supplemented by the US or European Emissions Annexes.

If you have any questions regarding any matters discussed in this briefing, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact.

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