



Nicholas Institute for Environmental Policy Solutions
Duke University

Carbon Market Design

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About the Nicholas Institute

- Nonpartisan institute founded at Duke University in 2005
- Engage with decision makers in government, the private sector, and the nonprofit community
- Created the Carbon Market Initiative to analyze the unique aspects of trading carbon allowances as a financial instrument





Setting the Stage

- Financial markets typically evolve over time
- Regulatory changes often follow the development of new financial products or respond to failures in the market system
- Carbon market debate is happening at the same time as Congress considers major reforms to financial regulation
- Congress is creating the carbon market from scratch
- Purpose – achieve environmental objective in a cost-effective manner
- Opportunity to get it right at the outset





Waxman-Markey: Market Oversight Subtitle

- What is covered?
 - Allowances
 - Allowance derivatives
 - Includes offset credits, with an exception for offset creation contracts





Waxman-Markey: Allowances

- FERC regulates
- Prohibit fraud, manipulation, excessive speculation
- Facilitate compliance with emissions limits
- Transparency
- Position limits and margin requirements, as necessary
- National market system
- Limit or eliminate counterparty risks, market power concentration risks, and other risks re OTC trading
- Standards for trading facilities and clearing organizations
- Other requirements necessary to preserve market integrity and compliance





Waxman-Markey: Derivatives

- Delegates to the President and an interagency working group
- Principles similar to the allowance section
- Default rules
 - 10% position limit
 - Trades executed on or through DCMs
 - CFTC regulates





The Role of Derivatives in a Carbon Market

- Tool for emitters to hedge risk
- Importance
 - Waxman-Markey
 - 38-year policy
 - 132 billion allowances over the life of the bill
 - Less than 5 billion allowances issued in 1st year of trading
 - Derivatives provide options for long-term allowance price certainty





Key issues – Avoiding Market Failures

- Transparency
 - Tracking trading activity – Who is trading, when, price changes
 - Type of information available to regulators, market participants, public
- Preventing manipulation/excessive speculation
 - *Manipulation* – direct attempt to affect prices
 - *Excessive speculation* – excessive risk that drives price volatility
- Managing market risk
 - Clearing
 - The role of unstandardized, over-the-counter instruments





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