

Design and Oversight of a Successful Carbon Market



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GETTING THE REGULATORY FRAMEWORK RIGHT



1. The ACES bill should first and foremost be designed to achieve the fundamental non-financial objective of a cap and trade program: curbing carbon pollution.
2. Regulating the carbon market offers unique challenges.
3. Designing a new market allows us to address these challenges one by one.
4. We have the tools to make sure that carbon trading is free of fraud and manipulation.
5. Important provisions have already been included in the ACES draft proposal to promote transparency, limit excessive risk taking, and penalize acts of market manipulation but more can be done to make these provisions explicit.

REGULATING THE CARBON MARKET – RECOMMENDATION 1

PARTICIPANTS SHOULD HAVE STRICT POSITION LIMITS



1. Position limits are used by regulators to ensure that no one participant has the market power needed to meaningfully influence prices.
2. Position limits are also used to ensure that the troubles or bankruptcy of any individual player (for whatever reason) do not disrupt the normal operations of the market.
3. While the ACES draft bill sets a position limit of 10% on derivatives, it is recommended that Congress look to lower the size of a participant's exposure to the carbon trading market or "position limit" from 10% to 5% in order to further reduce the impact of large players on the carbon markets.

REGULATING THE CARBON MARKET- RECOMMENDATION 2

TRADING SHOULD BE LIMITED TO EXCHANGES



1. While limiting derivatives trading to exchanges is strongly encouraged, Congress needs to weigh the benefits and costs of allowing unregulated transactions between two participants, known as over-the-counter (OTC) transactions in the carbon markets.
2. If it is determined that the benefits of OTC trading outweighs the risks, it is recommended that Congress require larger OTC trades (above \$10mln in nominal size) to have a reporting requirement into the regulator. This would discourage OTC trading by speculators looking to benefit from a lower level of transparency in the OTC market.

REGULATING THE CARBON MARKET- RECOMMENDATION 2

TRADING SHOULD BE LIMITED TO EXCHANGES



The following is a short list of the pros and cons of limiting trading to well regulated exchanges:

Pros

1. Exchange traded derivatives will trade for up to 10 years into the future, compared to only 2 years into the future for a commodity like oil. This reduces the need for OTC trading as a way to hedge longer term risks.
2. Exchange trading of derivatives dramatically reduces the "counterparty" or credit risk involved in derivative transactions.
3. Regulators can more easily monitor the market as all trading will be in one location.

Cons

1. OTC trading offers tailor made solutions to emitters to best manage their carbon liabilities.
2. OTC trading provides better tax treatment for hedging emitters longer term carbon liabilities.
3. OTC trading would allow emitters to hedge carbon together with their other energy inputs.

REGULATING THE CARBON MARKET- RECOMMENDATION 3

OVERSEAS US CARBON MARKETS NEED TO BE CONSIDERED



1. A multi-trillion dollar carbon market is expected to attract interest from overseas exchanges looking to facilitate trades during non-US market hours.
2. These exchanges will tend to have their own reporting criteria that may or may not be accessible to US regulators, leaving open the risk that market players could side step position limits on carbon trades by holding some or all of these allowances offshore.
3. In an effort to address this carbon leakage issue, Congress should look to establish a working group to address the issue as it relates to overseas exchanges looking to set up look alike US carbon contracts.