23 July 2010

IETA reply to public consultation on measures to ensure transparency and integrity of wholesale markets in electricity and gas[1]

1. General remarks on oversight of carbon markets[2]

1.1 IETA is the leading voice of the international business community on the subject of emissions trading with over 170 member companies from across the carbon cycle. IETA supports efforts to address the pressing environmental challenge of climate change, and is dedicated to the establishment of environmentally effective market-based emissions trading systems that generate reductions at least cost to the community.

1.2 The carbon market is different from other (commodity or financial) markets as (i) it is a regulated market, i.e. entities covered have a legal obligation to participate and allowances are produced and allocated by governments; (ii) it is a young market; (iii) it has many smaller participants; (iv) and its transactions are mostly traded on exchange or cleared.

1.3 However, the experience of IETA members strongly suggests that carbon trading is essentially similar to trading in markets for other commodities. Therefore, we do believe carbon market oversight measures should be coordinated with other commodity markets, in particular energy markets.

1.4 At the same time, one must avoid regulatory overlaps: in particular, IETA believes that prevention of market manipulation should be addressed within an appropriately defined market abuse framework encompassing both auctions of emission allowances and trade in spot and derivative carbon contracts via exchanges, multilateral trading facilities (MTF) and over-the counter (OTC). If an abuse of market dominance is being detected, anti-trust laws and competition authorities should be responsible.

1.5 We could indeed end up with several oversight regimes for the carbon market:

- MiFID and MAD cover the trading of financial products on regulated markets (and beyond) and thereby carbon market derivatives[3] that are traded on-exchange or cleared (or on MTF if a MAD revision is adopted by the beginning of 2011);
- The regulatory overhaul of derivatives and market infrastructure foreseen for September 2010 will enhance the clearing of OTC transactions and introduce reporting obligations for trade repositories which could also affect carbon markets;

[1] http://ec.europa.eu/energy/gas_electricity/consultations/2010_07_23_energy_markets_en.htm
[2] See also IETA's position paper of May 2010 on transparency and oversight in the EU's carbon market at http://www.ieta.org/ieta/www/pages/download.php?docID=3477
[3] Only applies to carbon derivatives that are cash-settled or have the option for cash-settlement.

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- A tailor-made regime for the power and gas markets could extend oversight by energy regulators to all EUA transactions;
- The auctioning rules for EU emission allowances will introduce market protection rules for the primary carbon market.

1.6 IETA would first like to see evidence from the work commissioned by DG CLIMA on whether the carbon market is sufficiently protected from insider trading and market manipulation, before any extension of market protection rules is undertaken.

1.7 It would be inappropriate to pursue an extension of MiFID/MAD rules to products that are not currently captured e.g. spot allowances or OTC forward contracts (without the option for cash settlement). Currently, these rules only apply to financial instruments, including cash-settled carbon derivatives.

1.8 A re-classification of spot EUAs as financial instruments would be possible but highly problematic. A recent report commissioned by the French government illustrates that financial regulation, designed for classical markets of financial instruments, is not always adapted or relevant for the CO_2 market.[4] One of the main points advanced is that rules would have to be adjusted to fit the regulatory purpose of the carbon market and that manifold exemptions were needed to carve out industrial end-users from obligations that are currently designed for financial players.

1.9 With 80% of current carbon derivatives transactions being cleared, a further argument for a tailor-made approach to the carbon market is that it hardly contributes nor is exposed to systemic risk. While this might change as the trading volume is expected to further rise in phase 3 of the EU ETS starting in 2013, increasing transparency coming from reporting obligations of standard OTC transactions might give a different evidence.

1.10 To achieve comprehensive monitoring of the market, traders should report non-cleared OTC transactions to a trade repository with harmonised contents and formats at EU-level. Moreover, an EU-wide regime is appropriate for standardising approaches to market monitoring and determining what constitutes abusive activity. Yet, market oversight/enforcement should be left to the relevant market operator, with support from financial and energy regulators, combined with effective communication and coordination between all relevant bodies.

2. Should integrity and transparency regime for power & gas markets cover carbon, too?

2.1 Carbon market oversight is similar to other commodity markets in that bilateral or over-the counter trade in spot allowances and OTC forward contracts (without option for cash settlement) are not regulated. Such transactions count for less than 20% of all carbon trading in the EU ETS. This gap is small but not insignificant. IETA believes that any scope for market abuse should be tackled.

2.2 There are indeed interdependencies between carbon and power/gas markets:

[4] The so-called *Prada* report, see http://lesrapports.ladocumentationfrancaise.fr/BRP/104000201/0000.pdf

- Fundamental factoring into each other's price formation process;
- Sharing market venues which facilitates trade execution and reporting;
- Underlying physical fundamentals (i.e. production/consumption/emissions) strongly influence each other's market outcomes;
- Power sector being the largest emitting sector in EU carbon market, representing 40% of total emissions covered by the EU ETS.

2.3 However carbon markets have also noteworthy differences from power/gas markets

- Various sectors participating in EU ETS are not linked to power and gas markets, i.e. power production by energy intensive industries for self consumption, other industrial processes and aviation, accounting for 60% of EU ETS emissions;
- Power and gas markets face physical constraints, i.e. electricity cannot be stored, gas only to a certain extent but cannot be delivered instantaneously. They are 'grid' commodities and despite efforts to accelerate EU-wide integration a certain degree of fragmentation still remain. Carbon does not face 'grid' constraints but can be traded, delivered and stored. The EU ETS is a EU-wide market by definition: one single market, one single currency;
- Price correlation with gas and power is observed to be low in certain studies;
- Companies covered by the ETS have a legal obligation to participate in this market.

3. Response to relevant questions

Q.14: Would monitoring of traded carbon markets be best organised on national or on EU level?
Q.15: If on EU level, do you believe that ACER could be an appropriate monitoring body?

3.1 Carbon market oversight can only be effective if regulators have an understanding of the power market. So it requires energy markets expertise and access to energy markets oversight data. Inversely, energy markets oversight will be increasingly dependent on a good understanding of what is happening on the carbon side. However, as stated above power accounts for 40% of EU emissions; while this is a significant proportion it does not follow that the natural home for the oversight of EUA transactions is the energy regulator.

3.2 An EU carbon market monitoring function, allowing for an effective coordination and exchange of data, could be introduced within either the European Securities and Market Authority (ESMA) or the Agency for Cooperation of Energy Regulators (ACER).

3.3 To prevent conflicts, regulatory overlaps and ensure appropriate cooperation between regulatory bodies, modalities are needed to ensure that the carbon market is fully captured, e.g. covering both spot/OTC forward and financial derivatives. This is important because derivatives transactions - ie futures - make the vast majority of volumes but serve essentially a function of forward 'physical' delivery (in other words, there is a continuum between the spot and the derivatives markets, the only difference being the delivery date).

3.4 National authorities would have to keep strong ties with the supervision and competition authorities of the various market sections and of nearby markets, such as power and gas.

3.5 Yet, market misbehaviour could be different from power/gas markets, e.g. 'fairly priced' is a concept that depends on capacity use in the power market but not in the carbon market. Also, concepts might have to be interpreted differently as 'misleading behaviour' in the carbon market could not be based on the movement of physical stocks[5] (that could create a wrong impression as to the value of a commodity).

3.6 IETA considers that these specific characteristics of carbon markets should not be overlooked but this needs to feed from and feed into energy markets oversight: same approach to trade repository, same approach to filling the market abuse regulatory gap on the physical markets, involve energy market regulator(s) without necessarily putting them in charge.

Q. 19: Do you agree the body with an oversight role requires full access to fundamental data relating to carbon?

3.7 IETA strongly believes that regulators should have access to all relevant information necessary to fulfil their regulatory/supervisory obligations. This includes - where appropriate and necessary - access to fundamental data, i.e. data relating to the amount of credits held, the volume of emission, etc.

3.8 However, this should be achieved via a single reporting channel for compliant entities. Regulators should be able to access relevant information (i.e. fundamental and transactional data) through EU-wide data repositories with proper disclosure rules, safeguarding the anonymity of individual market participants. This corresponds to a 'one-stop-shop' compliance for the carbon market, which could be the same for power and gas market participants. Fundamental data should be reported by national authorities that currently receive this information from companies covered by the EU ETS.

3.9 However, notwithstanding the above, IETA believes that reporting of transaction data should be done through the systems of exchanges, MTFs, brokers and central clearing platforms and, if applicable, by trade repositories; this would be an efficient and practicable response to the need for regulators to access relevant data without imposing a significant burden on individual firms.

[5] See http://fsahandbook.info/FSA/html/handbook/MAR/1