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Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets

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"One troubling aspect of cap and trade is that the speculators from Wall Street, Chicago and San Francisco are foaming at the mouth to get their hands on trading profits from cap-and-trade allowances. Hedge funds, private equity funds and other companies have been lobbying Congress to pass cap-and-trade legislation. In fact, Enron and AIG were early supporters of cap-and-trade legislation."

U.S. Senator Chuck Grassley, U.S. Senate Committee on Finance Hearing on "Auctioning under Cap and Trade: Design, Participation and Distribution of Revenues," May 7, 2009.

The Institute for Agriculture and Trade Policy (IATP) is a nonprofit, 501.c (3) nongovernmental organization, headquartered in Minneapolis, Minn. with offices in Washington, D.C. and Geneva, Switzerland. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since May 2009, and in international regulatory meetings; most recently, the European Commission's public hearing on commodity derivatives on September 21 in Brussels. IATP has written about carbon emissions markets both from the perspective of their purported capacity to induce investment to lower greenhouse gas emissions[1] and as the major proposed source of financing mitigation and adaptation projects under the United Nations Framework Convention on Climate Change (UNFCCC).[2] The following responses to the CFTC's questions about carbon emissions market oversight are partly drawn from these publications.

IATP is grateful for this opportunity to comment on issues to be considered by the interagency group in its carbon market study mandated by Section 750 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The following comment comprises responses to some of the 11 questions posed by the CFTC.

1. *Section 750 of the Dodd-Frank Act indicates that goals of regulatory oversight should be to ensure that carbon markets are efficient, secure and transparent. What other regulatory objectives, if any, should guide the oversight of such markets?*

Oversight of a mandatory carbon emissions market would be the greatest regulatory challenge ever faced by the CFTC. Given the heroic labor of the CFTC to implement Dodd-Frank, this opinion may seem a vast overstatement. After all, carbon dioxide emissions equivalents appear to be only "one" commodity. The CFTC market oversight and surveillance staff has announced that it is committed to "ensuring emissions market integrity."[3] However, beyond the many problems of implementing and enforcing Title VII of Dodd- Frank and other CFTC statutory authorities, creation of a carbon emissions market poses a unique problem, namely the environmental integrity of the underlying

assets of the derivatives and spot markets, carbon emissions permits ("allowances") and carbon offset credits. If the environmental integrity of these assets cannot be verified consistently on the basis of the best available science, the regulatory objective of the carbon market's environmental effectiveness cannot be achieved.

As the interagency working group begins to design its study for Congress, the CFTC should propose that the task force put at the top of its research agenda how the environmental effectiveness of carbon markets can be ensured. Items for that agenda should include which agency will be responsible for vouchsafing Certified Emissions Reductions (CERs); what additional authorities and resources it will need; and how that agency will be advised about scientific discoveries concerning climate change and carbon dioxide equivalent emissions. IATP believes that the interagency task force should request testimony by representatives of the international climate observation systems, e.g., the Global Terrestrial Observing System (GTOS).[4] GTOS testimony could explain the on-the-ground techniques, computer modeling parameters and methodological uncertainties of estimating the soil carbon baselines and verifying CERs that would form one basis for issuing U.S. carbon market-traded assets.

Failure to ensure the environmental integrity of the underlying assets is among the factors undermining the environmental effectiveness of the European Union's Emissions Trading Scheme (ETS). For example, with regard to CERs claimed for ETS offset projects involving Hydro-Fluorene Carbon 23 (HFC 23), Connie Hedegaard, the European Commission's Director General of Klima (Climate) stated, "there is a total lack of environmental integrity."[5] This is not a minor inconvenience caused by just one of the many CO2-equivalent greenhouse gases. According to a UNFCCC chart cited in a just-published study, HFC 23 accounts for 65 percent of CERS claimed in ETS 2008-09 offset trades.[6] In Germany, about 50 percent of industry compliance with Germany's ETC cap relies on CERs from Clean Development Mechanism (CDM) projects in China, Brazil, Mexico and elsewhere, of which about 83 percent are of "questionable environmental integrity" according to World Wildlife Fund Germany.[7] A 2010 Point Carbon survey reported that an average of 15 percent of 810 respondents believed Clean Development Mechanism or Joint Implementation offset projects to be corrupt or fraudulent. Ten percent of U.S. projects were so characterized while respondents judged 28 percent of Chinese CDM/JI projects to lack environmental and market integrity.[8]

According to a draft [U.S.] Energy Information Administration study, about 61 percent of anticipated U.S. GHG reductions by 2030 will come from buying offset credits, including about half internationally, under the terms of the American Clean Energy and Security (ACES) Act passed by the House of Representatives on June 26, 2009.[9] This heavy dependence on offsets for U.S. industry to meet GHG-compliance caps means that the environmental effectiveness of proposed U.S. legislation would rely on an underlying asset about which there are numerous scientific uncertainties and methodological disagreements about CER verification of offset activities. Even with improved legislative design, reduced tax and marketing fraud, and reduced deceptive carbon accounting, the environmental integrity of the underlying asset, upon which carbon market integrity rests, will be vulnerable to these uncertainties and disagreements. For example, there are no agreed international standards for remote sensing protocols or for *in situ* testing of essential climate variables, including land cover and biomass.[10]

2. *What are the basic economic features that might be incorporated in a carbon market that would have an effect on carbon market oversight provisions—e.g., the basic characteristics of allowances, frequency of allocations and compliance obligations, banking of allowances, borrowing of allowances, cost containment mechanisms, etc.?*

Carbon trading, according to FERN, a European NGO, "is only a cost management tool, which itself does not reduce emissions."[11] If the emissions cap is not stringent and/or not stringently enforced, the reduction in GHG emissions will be correspondingly small and the likely damage from climate change will be correspondingly large. For the United States alone, just the costs of climate change–related hurricane damage, real estate losses and disruptions to water and energy supplies under the current "business-as-usual scenario" have been conservatively estimated at $271 billion (in constant 2006 dollars) annually, beginning in 2025.[12] The interagency working group should produce a consensus document that estimates the costs and benefits of climate change policy under a range of policy scenarios, from "business as usual," to *de facto* industry self-regulation, to stringent interagency regulation, and to the command and control interventions required if the group determined that climate change was a national security threat that could not be reduced substantially through market-based mechanisms.

The U.S. voluntary pledge to the UNFCCC under the Copenhagen Accord is by 2020, from a 2005 self-defined baseline, an emissions cut "in the range of 17% in conformity with anticipated U.S. energy and climate legislation, recognizing that the final target will be reported to the secretariat in light of enacted legislation."[13] Although the interagency task force likely will model econometrically the carbon market of 2020 according to a 17-percent reduction forecast by U.S. policy scenarios, IATP believes that the cost-benefit analysis in public interest requirements of the Commodity Exchange Act would justify modeling according to more stringent reduction targets, e.g., those of the European Commission and Japan.

In theory, the "right" carbon market price signal, if reliable and sufficiently high and prolonged, should induce long-term investment in low-carbon production and energy facilities. Investment decisions are prompted as the cost of compliance with a progressively more stringent GHG cap exceeds the cost of the many cost-containment mechanisms proposed in U.S. legislation. In theory, these cost-containment mechanisms should allow for price "smoothing" and provide investor confidence in rate of return calculations for urgently needed long-term, low-carbon investments in a broad array of industrial sectors. Part of this price signal is legislated, and part is a private investor response to the legislative design of the market. As the Congressional Budget Office testified to Congress, "the [carbon] price increases would be essential to the success of a cap-and-trade program because they would be the most important mechanism through which businesses and households would be encouraged to make economically motivated changes in investment and consumption that reduced CO2 emissions."[14]

In practice, carbon market theory has not worked, e.g., in the European Union, partly because of legislative design elements requested and obtained by compliance industries and the financial services sector, and partly because of the aforementioned environmental integrity factors.[15] The Congressional Budget Office estimates that under U.S. legislation, the market would start carbon prices at $16 per Co2 tonne in 2012, rising to $26 a metric ton by 2019.[16] The Organization for Economic Cooperation and Development estimates that for the U.S., Canada, New Zealand and Australia, "carbon prices of at least USD 50 per tonne of Co2 eq[univalent] would be required if emissions are to return to 1990 levels by 2020."[17] The legislated under-pricing of carbon emissions, relative to what is required for effective environmental performance, would be less worrisome if carbon price signals were less volatile.

However, as the European Commission's Director General of Environment testified to Congress, the free allocation of carbon emissions permits to covered industries, together with the banking and borrowing provisions for those allowances, were among the factors that have resulted in low and volatile carbon prices under the ETS.[18] For example, covered industries that had received billions of euros in windfall profits through the free allocations were not motivated to defend the price of their

allowances against short sellers.[19] The Obama administration originally intended to auction off a major portion of the emissions permits, but gave about 83 percent for free in ACES due to industry lobbying, to have a chance of getting any climate and energy legislation passed.[20] If future legislation for mandatory cap and trade is passed by Congress, it will likely feature a free allocation of most emissions permits, and banking and borrowing of credits, with the consequent tendency towards volatility experienced under the ETS. The interagency working group should evaluate and report on whether the auction only and other provisions in the CLEAR Act proposed by Senators Cantwell and Snowe would result in higher and less volatile carbon prices.

A perhaps too little mentioned feature of carbon trading under the ETS is its share of over-the-counter carbon derivatives trades—about 44 percent in 2008.[21] OTC traders have a price information advantage over exchange trades that are reported daily to regulators. OTC traders contribute no timely information to significant price discovery, and yet they benefit from the information of exchange reported trades. Given this information advantage, and lucrative OTC fees, it is not surprising that the International Emissions Trading Association (IETA) has proposed that any restrictions under the forthcoming EC OTC directive be relaxed for carbon trading: "A balance has to be struck to avoid disproportionate or ill-conceived transparency requirements that negatively impact liquidity in what is still a young and growing market."[22] IETA contends that if carbon markets are as transparent as regulated exchanges, investors will not invest in carbon. To the contrary, IATP believes that the CFTC should resist any attempt to widen on behalf of carbon traders the Dodd-Frank end-user exemption for OTC trades. The counter-party risks posed by OTC trades to market integrity, particularly if one party is a major swaps dealer or is an affiliate of a major swaps dealer, greatly outweighs the small commercial advantage to end users of so-called "customized" swaps. Furthermore, delayed, incomplete and inaccurate reporting of OTC trade data often results in rumors and herd behavior that drives price volatility.

3. *Do the regulatory objectives differ with respect to the oversight of spot market trading of carbon allowances compared to the oversight of derivatives market trading in these instruments? If so, explain further.*

The interagency study may wish to define regulatory objectives for spot and derivative carbon markets in terms of how and why investors participate in the respective markets, and adjust objectives accordingly. GHG emitters participate in the spot market to comply with GHG caps. The environmental integrity of the offsets and allowances directly affects whether or not emitters have complied. Financial speculators in the derivatives market would not, under proposed U.S. legislation, suffer compliance sanctions if the underlying assets—upon which the derivatives are based and profits are made—prove to be erroneous, deceptive or even fraudulent representations of CERs. Although both spot and derivatives markets should fulfill the parameters of an environmental-effectiveness objective, government control over supply and demand in the spot market versus the open-ended, market-driven supply and demand of the derivatives market, will require some different regulatory tools to achieve the objective.

Unlike consumable commodity markets, in the mandatory compliance market of a legislatively created commodity, the government is the sole supplier of the spot market's underlying asset. Assuming that the environmental integrity of carbon allowance and offset credits can be ensured, the spot market supply of the carbon markets' underlying assets should be publicly known, unlike the uncertainty about physical stocks that have left markets in consumable commodities vulnerable to market manipulation. The government also creates demand for carbon allowances according to the stringency of the carbon emissions cap and the various cost containment and "flexibility mechanisms" to enable covered industries to comply at the least cost to them. Firms whose GHG

production exceeds what is allowed by their cap will use the allowance and offset spot market to comply with that cap.

It is not clear why financial investors with no compliance mandates should be allowed to participate in the carbon spot market. Insofar as emitters likely will be receiving carbon allowances worth $50–300 billion by 2020, according to the Congressional Budget Office,[23] under the ACES policy assumptions, there is no good public policy reason why part of the allowance giveaway revenues could not form a liquidity pool for compliance entities trading in the spot market. The purported need for financial speculator liquidity in the spot market would be obviated. The interagency working group should deliberate and make a recommendation as to whether financial speculator participation in the spot market is required to fulfill the paramount objective of environmental effectiveness. The group should also examine whether cross-market manipulation between spot markets—particularly in offsets, and the derivatives market—has occurred on a scale such that the group would advise against financial speculator participation in spot markets.

4. *Are additional statutory provisions necessary to achieve the desired regulatory objectives for carbon markets beyond those provided in the Commodity Exchange Act, as amended by the Dodd-Frank Act, or other federal acts that may be applicable to the trading of carbon allowances?*

As indicated in our response to Question 1, verifying and certifying the environmental integrity of carbon offset credits will pose a huge regulatory challenge. Existing regulatory and law enforcement tools against fraud and deceptive marketing and accounting will not suffice to address the problems posed by evolving science that can demonstrate claimed CERs to be erroneous in their environmental effectiveness. The interagency working group may wish to consider whether a statute is needed to establish a standing scientific advisory panel for the CFTC and other agencies with carbon market oversight responsibilities.

For carbon market derivatives, the existing statutes to minimize conflicts of interest between risk rating agencies and broker dealers may not suffice, given the extent to which current legislative design relies on international offset credits for covered industry compliance. For example, Christiana Figueres became the secretary of the UNFCCC after she had been appointed in March 2009 as vice-chair of the Carbon Ratings Agency and Chairman-designate of Carbon Ratings USA.[24] Among its products and services, the Carbon Ratings Agency states, "An important outcome of our risk analysis is an independent opinion on the likely performance of an emission reduction project." Many of the CRA rated projects are verified by the UNFCCC's and World Bank's Clean Development Mechanism, which is under great pressure to deliver more offset credits. Figueres' UNFCCC and CRA responsibilities could at least give the appearance of a conflict of interest detrimental to the environmental integrity of CDM-approved offset credits that could enter U.S. spot and derivative carbon markets. Other former UNFCCC and World Bank carbon market officials are CRA employees or consultants with entrée to the CDM Executive Board. Whether or not there is a conflict of interest among these officials, the interagency working group should review whether the credit ratings agency and conflict of interest provisions of Dodd-Frank suffice to ensure both the market integrity and environmental effectiveness objectives of carbon markets, particularly where carbon rating agencies are concerned.

7. *To what extent is it desirable or not desirable to have a unified regulatory oversight program that would oversee activity in both the secondary carbon market and the derivatives market?*

It is imperative to have a unified regulatory oversight program, not only to better prevent cross-market manipulation and regulatory circumvention, but in order that regulators can evaluate real-

time reporting of carbon trades in both kinds of markets. The interagency working group should draw lessons learned from the oversight fragmentation, deregulation and de-supervision that contributed to the financial service industry meltdown of 2008 and apply those lessons to carbon market oversight. Carbon markets have been forecast to become the most important commodity, in terms of notional value of contracts, overseen by the CFTC. Even if those forecasts were just a tenth correct in terms of notional value, the environmental effectiveness objective of carbon markets should compel the interagency working group to advise Congress of the need for a unified regulatory oversight program.

8. *To what extent, if any and how should a U.S. regulatory program interact with the regulatory programs of carbon markets in foreign jurisdictions?*

The global carbon market advocated by the Organization for Economic Cooperation and Development and the World Bank is likely more than a decade from realization. At the UNFCCC Conference of Parties in Cancún, Mexico, World Bank President Robert Zoellick announced a multi-million dollar "Partnership for [Carbon] Market Readiness" to prepare developing countries to participate in a global carbon market.[25] Nevertheless, if carbon markets are to become the main policy instrument for inducing investments to reduce GHG emissions to levels sufficient to mitigate the ravages of climate change, more intensive and intentional regulatory cooperation will be needed beyond what is specified in Dodd-Frank. The CFTC already maintains an active regulatory cooperation program with the European Commission. This program will be enhanced if the Commission decides to establish a European commodity regulatory authority to reduce the notorious regulatory arbitrage among EU member state markets and traders, including that which recently resulted in the suspension of carbon trading in Italy.[26]

In addition to recommending greater transatlantic regulatory cooperation, the interagency working group should consider how best to enhance regulatory cooperation in foreign jurisdictions with fast-emerging carbon markets, such as Brazil's BOVESPA. One way to expedite international cooperation would be for the CFTC to propose the creation of a carbon market technical committee of the International Organization of Securities Commissions (IOSCO). IOSCO's experience in drafting voluntary best practice guidelines will serve the market-integrity objectives of carbon markets. However, the interagency working group also should consider how U.S. regulatory cooperation programs can obtain and disseminate cutting-edge technical and scientific information on GHG emissions. Although Congress does not wish to be bound by UNFCCC obligations, it may support an international regulatory cooperation program that would be advised by the International Panel on Climate Change and/or any of the aforementioned global climate observation systems that provide data to the IPCC.

Conclusion

The CFTC's capacity to effectively regulate carbon markets will depend greatly on the legislative design of those markets (and an adequate budget for the agency). Therefore we agree with Michelle Chan's well-documented view that the smaller and simpler the legislative design of carbon markets, the more likely that they will fulfill market integrity objectives and indirectly contribute to complying with mandated GHG reductions.[27] IATP wishes to thank the CFTC for the opportunity to respond to its far-reaching and thought-provoking questions. We look forward to the opportunity to comment on the draft interagency carbon market report.

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