Supporting the Design and Implementation of Emissions Trading Systems in China - 中欧碳交易能力建设项目

Market Oversight Part 1: European Context

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Current status → **Capacities built over time** → Well-functioning China National ETS

- Road maps
- Cap setting
- Allocation
- MRVA
- Registry
- Market oversight

BACKGROUND

A well functioning market for emissions allowances (1)

- A well – functioning market for emissions allowances and offsets provides a common platform for all firms (compliance operators) to balance supply and demand of emissions (and consequent reductions), and to establish a single market – clearing price.

- Firms can then respond to this market price to make abatement choices and to become either buyers or sellers of allowances or offsets, depending on each firm's emissions reduction costs relative to the market price.

- The market may also provide a central location for firms to transact business without having to seek out one another individually.

A well functioning market for emissions allowances (2)

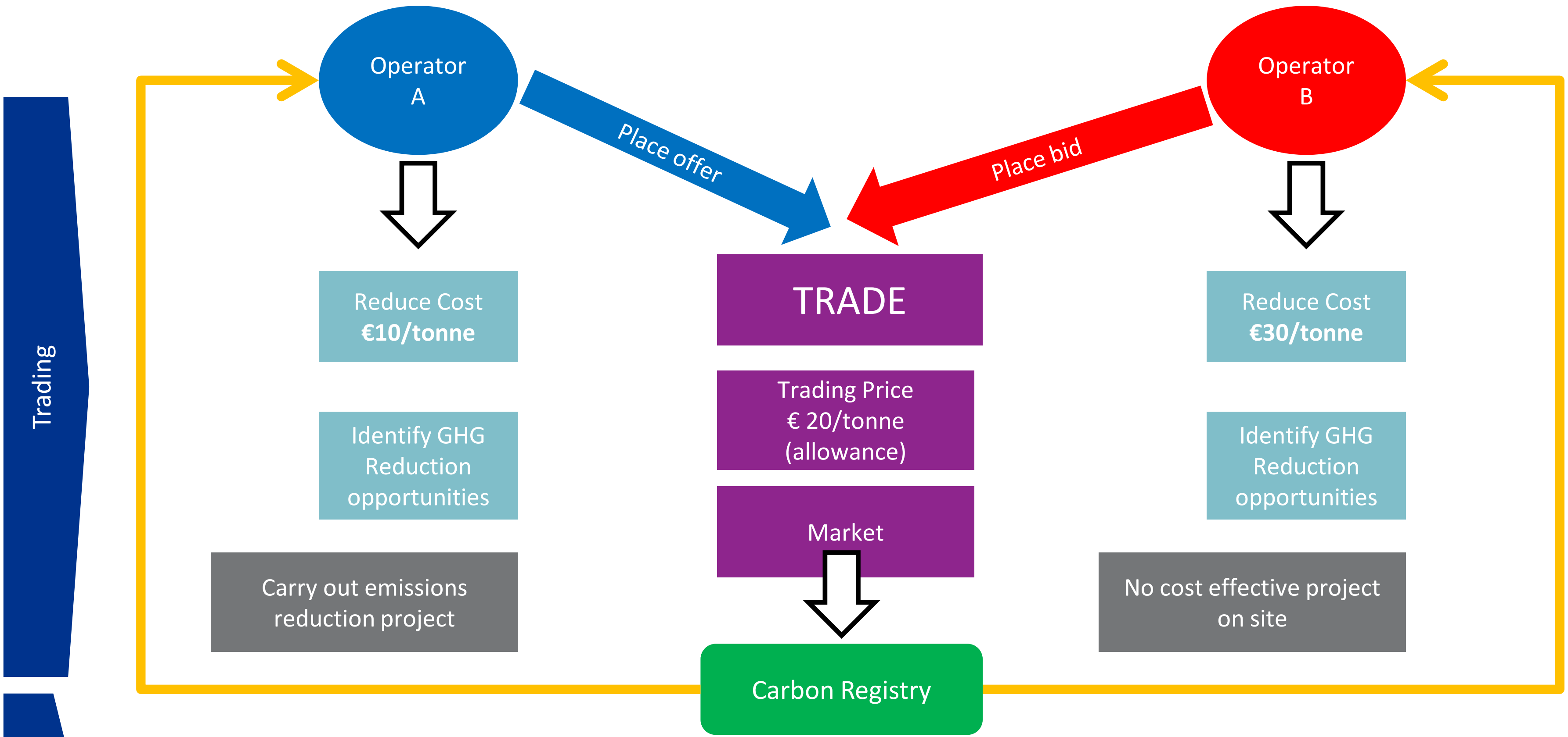
- It is important that ETS markets exist and provide market-clearing prices not just for current emission allowances or offsets, but also for emissions allowances and offsets into the future, as companies face investment decisions with long-term emissions consequences.

- In addition to establishing the market clearing price, to achieve low compliance costs, markets should also provide relatively easy access to transactions at these prices for all participants facing mitigation decisions.

- Significant explicit or implicit transaction costs will prevent otherwise desirable trading activity from taking place. Such inefficiencies are undesirable in any market.

Why use the market to trade ?

Example: Compliance Operator (for illustration purpose only)



Compliance

Allowances
Allocated: 1000 allowances
Annual Report – 800 allowances

SELL 200 allowances

Allowances
Allocated: 1000 allowances
Annual Report – 1200 allowances

BUY 200 allowances

THE EU ETS MARKET

DEFINITIONS
PRIMARY MARKET
SECONDARY MARKET
TRADING PRODUCTS
TRADABLE UNITS
MARKET ACTORS

Definitions

- Exchange
  - A marketplace in which shares, options, futures and other derivatives on stocks, bonds, commodities, and indexes are traded.

- Trading platform
  - An (electronic) trading platform is a computer system that can be used to place orders for financial products over a network with a financial intermediary or counterparty, such as a brokers, market makers, investment banks or stock exchanges.

- Over The Counter (OTC)
  - A bilateral transaction between a client and a bank, negotiated privately between parties

- Forward
  - Calculation uses information known now to infer where an asset will trade in the future
- Option
  - An agreement between two parties that gives the holder (buyer), the right but not the obligation to buy or sell a specific instrument at a specified price on or before a specific future date.

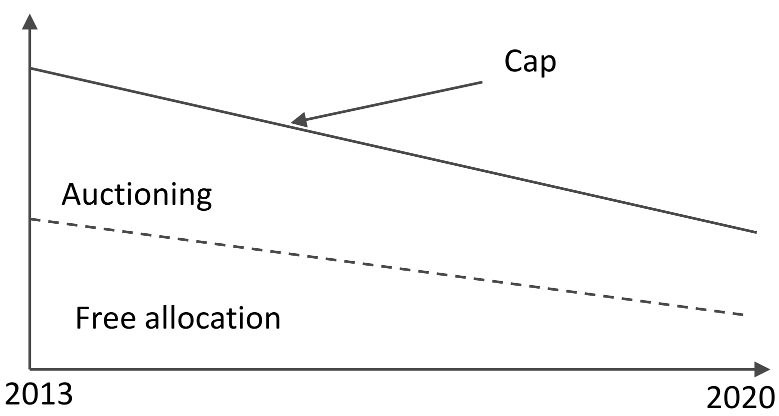
The Primary Market

- Under any carbon market, a mechanism is needed to introduce emissions allowances and offset credits into the marketplace. **This entry point is the primary market.**

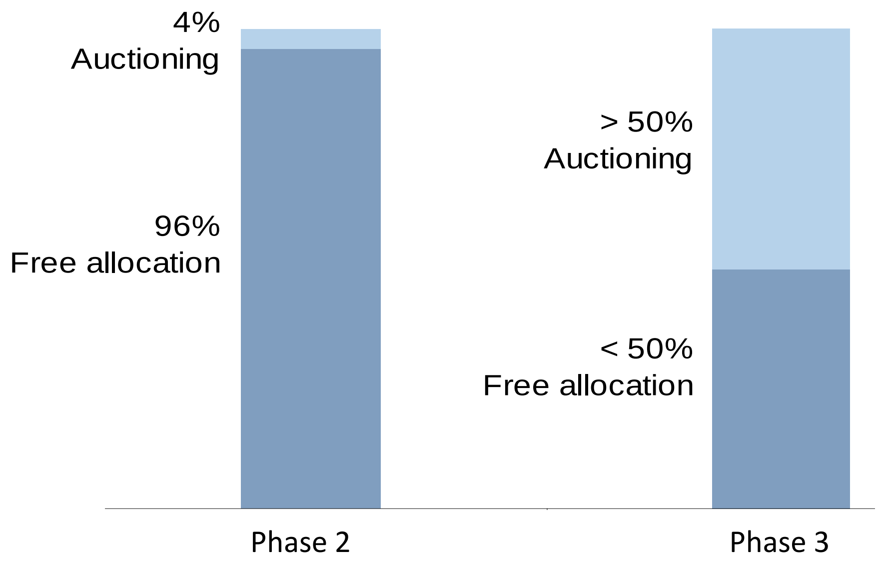
- EU ETS Primary Market (Free allocation & auctioning)

- Auctioning is becoming the principal method of allocation of allowances

Evolution of the primary market over phase III of the EU ETS



Free allocation & auctioning in the EU ETS



Secondary Market

Once emission allowances have been introduced through a primary market, the efficient functioning of carbon markets depends on the ability of entities to freely trade them in response to changes in their demand for allowances and offsets.

Type of transactions:

<table>
<tr><th colspan="5">Types of transactions</th></tr>
<tr><td rowspan="3">Transactions within exchanges</td><td colspan="4">Transactions outside exchanges (Bilateral or OTC)</td></tr>
<tr><td colspan="2">Cleared at exchanges</td><td colspan="2">Not cleared</td></tr>
<tr><td>Intermediated</td><td>Not intermediated</td><td>Intermediated</td><td>Not intermediated</td></tr>
</table>

Source: World Bank,2012 & Point Carbon

Trading Products

- Spot
  - Immediate settlement
  - No credit charges or margin payments
  - The entire value of the purchased units paid at time of transaction

- Future
  - Standard contract that is traded on an exchange
  - Delivery and payment at a specific time in the future
  - Allows for fixing the price now, but paying at delivery (cash-flow advantage)

- Forward
  - OTC transaction

- Future
  - Owning the right (without obligation) to buy/ sell an EUA at a given price

Tradeable Units Under EU ETS

- Underlying physical products for carbon trading

European Union Allowance (EUAs)

- ✓ Traded within EU ETS
- ✓ a uniform commodity 1 EUA = 1 ton of CO_2e
- ✓ Lives from the moment of allocation (issuance) to the moment surrendering for compliance
- ✓ Allocation, physical transfer, surrendering and cancellation takes place through the Union Registries

Certified Emissions Reductions (CERs) and Emissions Reduction Units (ERU's)

- ✓ Traded globally but linked to EUETS
- ✓ a uniform commodity 1 CER/ERU = 1 ton of CO_2e
- ✓ Lives from the moment of issuance (in CDM/JI registry) to the moment of surrendering for compliance
- ✓ Not all CERs/ ERUs are accepted for compliance under EU ETS

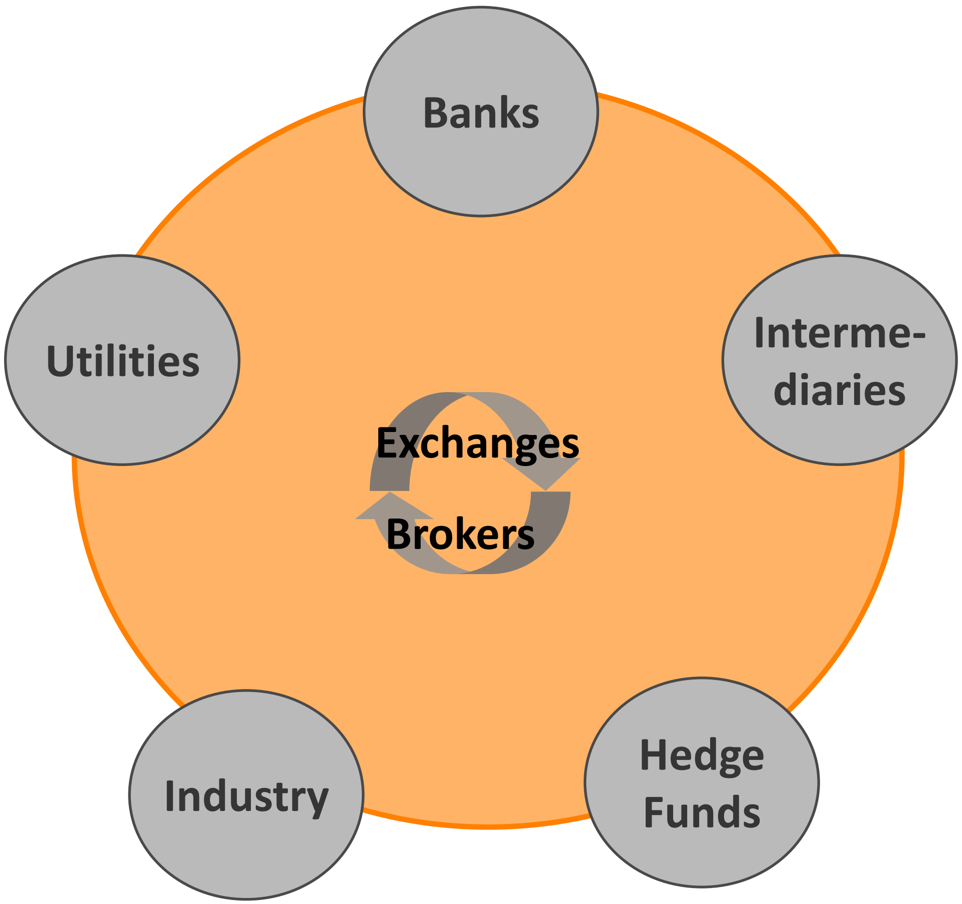
Who uses the market?

- ETS operators
  - Typically they sell surplus allowances or buy deficit
  - A small number of larger ones (i.e. electricity, large industries) have developed strong trading arms serving other ETS operators

- Banks, brokers and (energy) commodity traders
  - Dealing on their own account or for their clients

- CDM Developers (CER /ERU)

Who are the market players?



- Market is determined by compliance obligations and speculative trading
- Portfolio optimisation due to monetary value of allowances

Source: Point Carbon, 2013

THE MARKET OVERSIGHT REGULATION

OVERVIEW
MIFD - MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE
MAD - MARKET ABUSE DIRECTIVE

Market Oversight

The objective of market oversight is to ensure that price determination in a market is accomplished efficiently, fairly, and openly so as to reflect the forces of supply and demand.

Regulators often focus on four areas of concern that potentially influence how well a market functions:

- Facilitation of price discovery;
- Market transparency;
- Optimal market participation;
- Prevention of manipulation;
- Fraud and other abuses.

EU ETS Market Oversight Rules

- Carbon markets to be covered in full by financial markets rules:
  - Auctions: market abuse framework and rules against money laundering apply; auction platforms to be regulated markets in MiFID sense
  - •Secondary market: allowances to be covered by the reviewed Markets in Financial Instruments Directive and Regulation (MiFID/MiFIR) and Market Abuse Directive and Regulation (MAD/R) with necessary adjustments
  - •Allowances to be classified as a new, separate category of financial instruments for MiFID and cross-referring legislation

Why rely on financial market rules?

- Two well-known and tested frameworks to enhance carbon oversight:
  - MiFID/MiFIR – applies to trading venues, professional traders and intermediaries – deals with organisation and transparency of markets – benefits investor protection, market integrity and efficiency
  - MAR/MAD – applies to all market participants – sets out framework against market manipulation and insider dealing
- Efficiency gains – in development and in implementation - for authorities and for market participants
- Appropriate adaptations to carbon market specificities foreseen and exemptions from MiFID for ETS compliance buyers

REFERENCES

Further information

For more information see:

- **http://ec.europa.eu/clima/policies/ets/oversight/index_en.htm**

- **http://ec.europa.eu/internal_market/securities/index_en.htm**