

March 4, 2008

The Honorable Dianne Feinstein  
The Honorable Olympia Snowe  
United States Senate  
Washington, DC 20510

Dear Senator,

I am writing to provide comments of the International Emissions Trading Association (IETA) on the subject of carbon market oversight. IETA recognizes your leadership in introducing S.2423, the Feinstein-Snowe Emission Allowance Market Transparency Act of 2007, and is grateful to your staff for taking the time to discuss this important subject with IETA member companies.

IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our 180 member companies include some of America's and the world's largest industrial and financial corporations, including global leaders in oil, electricity, cement, aluminum, chemical, paper, and banking; as well as leading firms in the data verification and certification, brokering and trading, legal, and consulting industries. A complete list of our members is attached.

## **I. INTRODUCTION**

IETA appreciates the opportunity to exchange views on how to create a robust, competitive carbon market in the United States that will achieve the desired environmental and economic goals. We agree that the policy needs to create a framework for participants to deliver value to shareholders, investors and customers, and it must guard against abusive market behavior.

For emissions markets to deliver on these promises, public policy needs to –

- Set clear environmental targets;
- Foster trading and innovation, both technological and financial;
- Encourage competition;
- Promote liquidity with simple rules, fair access and transparency;

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- Ensure integrity by guarding against abuses without discouraging legitimate participation; and
- Provide robust systems to enable the above.

To that end, IETA shares the spirit and the goals of the S. 2423. We agree that fraud and manipulation should have no place in carbon markets. But our vision of a national and global carbon market has significant differences from the regional power market that caused the Western Energy Crisis earlier this decade. Properly structured national and international carbon markets would have a size and geographical reach that would be less prone to fraud and manipulation than the Western power market. However, we want to work with Senators to ensure that if any residual risk of abuse exists, it is appropriately addressed in legislation.

After introduction of S. 2423, IETA began consulting with members about whether the proposed solutions are appropriate or could be improved. This consultation is still underway, and as it proceeds IETA would like to engage in an ongoing exchange of views with interested Senators as we consider alternatives. We want to focus our evaluations so that any approach to oversight will be "fit-for-purpose, fit-for-market." We begin with several observations below.

## **II. OBSERVATIONS**

Our views grow from six observations from our collective market experience.

1. Integrity is central to the proper functioning of any market – especially new and innovative carbon markets. As market participants, IETA members are keenly aware of this central premise. When there are market failures, our businesses suffer. When the market is trusted, our businesses are stable – and thrive.
2. Size matters in assessing potential for market abuse. A large national GHG market in the United States would be difficult for a single firm to dominate or manipulate, particularly if allowances are allocated widely across the covered sectors (as opposed to being auctioned).
3. The market itself recognizes the importance of integrity and exerts discipline on participants. Emissions trading contracts contain enforceable penalties against fraud. Trading companies set their own trading limits to guard against excessive speculation. The market itself punishes firms that exceed responsible limits by downgrading credit ratings, lowering lines of credit or barring individuals or firms from trading. Members of exchanges can be fined, suspended or ejected for trading beyond approved limits.



4. Internal market controls may not be sufficient. In any market, there is potential for fraud, corruption and anti-competitive behavior – and government must ensure that adequate protections are in place to guard against such abuses.
5. Some protections will be built into the design of the trading system, and others will emerge in contractual protections and the entrepreneurial innovation. Other protections exist in federal law already. We want to explore the extent to which existing legal protections can meet this need before concluding whether a specific agency needs to be charged with carbon market oversight – or which agency should be so empowered.
6. Any solutions to fraud prevention and market oversight should be administered efficiently with robust systems that enable market transparency and agency reporting. We are concerned that any legislated solution should not impose overly burdensome or inefficient reporting obligations, because it could discourage participation in the market by legitimate smaller firms.

### III. INITIAL ANALYSIS

In terms of process, we believe that before determining whether a specific market oversight is warranted, it would be valuable to:

- Focus on the nature of the carbon instruments, the market context in which they are used, how those instruments will be issued and tracked, and how severe the risk is of market abuse.
- Identify the existing anti-corruption policies governing traded markets in the United States to determine whether any further policies are needed.
- If further policies are needed, conduct a careful evaluation of how to narrowly tailor these new policies and regulatory powers to the specific problems envisioned.
- Assess whether (and which) existing agencies could implement the policies in the most efficient ways – taking into account the need to ensure that the interaction of market participants with government regulators is efficient. This evaluation should also consider which agency has the necessary skills and experience required for effective governance. Ideally, this evaluation should highlight which agency (or new entity) is best suited to fulfill the mission.

#### 1. NATURE OF THE INSTRUMENTS

The legal community involved in carbon markets continues to debate whether carbon allowances are akin to an existing instrument, such as commodities, securities or currencies, or whether they are simply a unique non-property right. IETA will discuss this further with legal experts in our membership to determine whether categorizing



allowances as one of these instruments might provide insight as to what agency is best prepared to oversee this new market.

2. MARKET CONTEXT

We support the establishment of a broad national greenhouse gas market that is linked with international carbon markets. The traded instruments should be sanctioned by governments (or approved UN organizations) and recognized for compliance globally. The large size of this type of carbon market is likely to make it extremely difficult for a single organization to dominate or manipulate it to its advantage.

The extent of auctioning employed in a future emissions scheme could significantly impact the susceptibility of the market to manipulation and abuse. An allocation scheme in which allowances are distributed broadly across numerous industry sectors would make it virtually impossible for a single participant or group of participants to corner the market. Existing environmental markets allocating allowances based on historical emissions, such as the US SO<sub>2</sub> and NO<sub>x</sub> market, have reported no substantial problems with market manipulation or abuse, despite the much smaller size, and consequently greater susceptibility to exertions of market power, of these markets. Since large-scale auctions have yet to be successfully demonstrated in environmental markets, it is difficult to predict the extent to which manipulation could occur in such a market. IETA believes this lack of experience warrants a cautious approach, and for this and other reasons is opposed to initial large-scale auctions.

3. ISSUANCE, TRACKING & CONTROL OF ALLOWANCES PROTECTS AGAINST FRAUD

We envision that the EPA or other responsible entity will ensure a system providing the essential functions of issuance, registry, tracking and compliance-tendering of allowances. These functions are essential for trading, settlement and protection against fraud and counterfeit in an emissions market. However, we are unconvinced that EPA needs to gather information on pricing, volumes and contract structures in order to fulfill these functions.

We also understand the market sensitivity of environmental compliance information and data. We support fair and open public release of data from compliance reports in a way that protects confidential business information. The European Union's (EU's) initial experience with release of compliance data was poorly administered and resulted in unfortunate market volatility in 2006. The EU's next experiences with data release were well-coordinated, fair to participants and easily accepted by the market.

4. ARE ADDITIONAL MARKET OVERSIGHT POWERS NEEDED?



In existing environmental markets, no new market oversight or regulatory powers have been deemed necessary. As a result, governments do not typically collect pricing information in these markets. Instead, they monitor news reports on market performance, and the transparent bid, offer, and transaction prices on regulated futures exchanges such as the European Climate Exchange and Chicago Climate Futures Exchange. Fraud and market manipulation are governed by existing trade or competition authorities, including the UK Financial Services Authority and the US Commodity Futures Trading Commission (CFTC). In the US, CFTC oversight is bolstered by the active market surveillance and participant qualification procedures employed by the National Futures Association, a self regulatory organization established to operationalize additional market oversight as provided in the Commodity Exchange Act (CEA). In the European Union Emission Trading Scheme (EU ETS), the European Commission's approval of national allocation plans includes review by competition (anti-trust) authorities to ensure that no unfair state aid is provided to companies. As the market functions now, the normal market compliance systems in various European Member States provide the anti-corruption protections for the market.

5. *IF ADDITIONAL OVERSIGHT IS NEEDED, WHAT AGENCY IS BEST SUITED TO GOVERN?*

IETA is evaluating to what extent further oversight is necessary, if at all, and what agency or agencies would be adequately suited for this function. While it would ease reporting burdens if a single entity were charged both with environmental and market oversight, we believe that EPA has little experience and expertise to draw upon in conducting oversight of fraud and market manipulation. These functions might be better addressed by the Department of Justice's Antitrust Division, the Federal Trade Commission, the Securities and Exchange Commission, the Federal Energy Regulatory Commission or the Commodity Futures Trading Commission. We will continue to explore this issue with the IETA membership.

6. *SHOULD GOVERNMENT COLLECT AND RELEASE MARKET INFORMATION?*

If policymakers determine that market oversight authority needs to be specifically assigned for the carbon market, we understand that it will need reliable information. Similarly, businesses need access to good information on volumes, prices and structures as they participate in the market. Private news organizations are currently meeting these needs reliably in existing carbon and acid rain markets. Market participants support these entities with trading data in a way that protects confidential business information. We appreciate the fact that S.2423 acknowledges the value and potential utility of existing price publishers and information, which we believe could provide an avenue for easing the reporting burden on industry.

**IV. CONCLUSION**



In closing, we want to stress that although environmental markets – particularly the acid rain and carbon markets – are relatively young, there have been no major incidents of price manipulation, anti-competitive behavior or fraud in these markets for compliance instruments. While acknowledging that additional study is necessary, this experience suggests that existing regulatory bodies should be able to deal with any possible price manipulation problems that might arise in a future mandatory US CO2 market. IETA is evaluating to what extent further oversight is necessary, if at all, and what agency or agencies would be adequately suited for this function.

Thank you again for your leadership in this important area. We look forward to continuing the dialog with you on the issue of market oversight. Please do not hesitate to contact me or David Hunter, IETA's Director for US Policy in our Washington office, if we can be of any assistance.

Yours truly,

Henry Derwent  
President and CEO  
International Emissions Trading Association