



1C Fosseway Business Center, Stratford Road  
Moreton-in-Marsh GL56 9NQ, UK  
Phone: 44 1608 652 895 Fax: 44 1608 652878  
jutta@fern.org  
www.fern.org www.sinkswatch.org

17 December 2010

17 December 2010

Mr. David A. Stawick  
Secretary of the Commission  
Commodity Futures Trading Commission  
Via electronic submission

Dear Mr. Stawick,

FERN is pleased to provide comments to the CFTC and the interagency working group for its forthcoming study on the oversight of existing and prospective carbon markets. FERN, a not-for-profit organization based in Brussels, Belgium and Moreton-in-Marsh, UK, works to achieve greater environmental and social justice, focusing on forests and forest peoples' rights in the policies and practices of the European Union. FERN has been monitoring and analyzing the development of the carbon markets for the past 10 years, with a particular emphasis on the EU Emissions Trading Scheme (EUETS) and the trading in carbon offset credits. We have summarized our analysis in a recent publication "Trading Carbon. How it works and why it's controversial"<sup>1</sup>. Key lessons we have taken from this analysis are that:

(1) Carbon markets as designed by the Kyoto Protocol and the EU ETS differ significantly from the sulphur dioxide pollution trading scheme pioneered in the USA as part of the EPA's Acid Rain Programme in two regards: (a) these carbon trading schemes allow for the use of offset credits and (b) trading was introduced in the absence of direct, real-time measurement of the pollution to be regulated being available and hence, almost all calculation of the volumes of pollution reduced are by proxy. Both of these differences have caused significant, and as yet unresolved, regulatory challenges to the EUETS as well as the Kyoto Protocol's carbon offset mechanism, the Clean Development Mechanism (CDM). These challenges are maybe more pronounced in the case of carbon offsets whose claim for additional emissions reductions cannot ultimately be verified, but they also affect the trading in emissions permits.

(2) The EUETS has been designed to allow both entities whose emissions have been capped as well as other financial actors without an emissions target to trade in the scheme.

<sup>1</sup> Jutta Kill et al., *Trading Carbon: How it works and why it is controversial*, FERN, August 2010 <http://www.fern.org/tradingcarbon>  
; Abridged version: <http://www.fern.org/designedtofail>

***FERN works to achieve greater environmental and social justice, focusing on forests and forest peoples' rights in the policies and practices of the European Union.***

Architects of the EUETS appear to have underestimated the consequences of these two groups of actors in the scheme having diametrically opposed objectives regarding price development: While entities covered by the EUETS look to the trading scheme to deliver a predictable carbon price which allows the entities to hedge their exposure and base long-term energy infrastructure investment decisions on the carbon price, the primary objective of most non-compliance actors is the generation of price volatility.

(3) A trading scheme that is open to non-compliance actors and which allows trading across different jurisdictions will be easy to game and difficult, if not impossible to effectively regulate. Architects of the EUETS underestimated the attraction such open trading schemes will pose to fraudsters and organized crime and that in order to prevent fraud, rigorous design and due diligence *before* actors are allowed to open trading accounts, is essential. The EUETS has already seen a number of incidents of fraudulent trading, in three cases causing spot trading bourses to close trading activity for day(s). These incidents suggest that the architects of the EUETS appear to have underestimated the importance of the design on the functioning of the trading scheme – and that in fact subsequent regulation will not be able to remedy the flaws of poor design.

(4) The creation of a carbon market has commenced even though the underlying assets of the carbon derivatives and spot markets are poorly defined. One could further argue that while carbon permits (“allowances”) and carbon offset credits have been defined to be fungible and interchangeable, they are in fact not comparable. While it may be possible in theory to establish the environmental integrity of a carbon permit, verification of the value of a carbon credit is not possible by definition as it requires evaluating a hypothetical, counterfactual baseline against which the volume of offset credits is calculated. Consequently, the error margins resulting from inadequate methodologies to quantify carbon offset volumes are significant, and far above error margins accepted as industry standard in derivatives trading. These methodological shortcomings pose considerable problems for the determination of margins required if such trades were to be cleared or for detecting symptoms of non-performance. Many CDM registered offset projects have been issued significantly fewer offset credits than had been predicted in ‘Project Design Documents’ which include detailed calculations of expected volumes of emissions reductions – documents which had been validated by auditing firms accredited with the UN’s CDM.

(5) The emergence of complex carbon derivatives even in the absence of a clear definition of the underlying asset opens the door to significant manipulation, gaming and fraud in trading schemes whose primary objective was to lower cost of implementation of greenhouse gas emission caps. Yet, the secondary and carbon derivatives markets that have developed from the demand created by the Kyoto Protocol, and EUETS targets generate significant trading volume and notional value but much of the profit generated through this trading activity accrues not to the entities covered by the emissions limits nor is it available for investment in low-carbon energy infrastructure.

In conclusion, the EUETS and the Kyoto Protocol’s carbon trading schemes have been designed to fail and it is difficult to see how subsequent regulation could remedy a situation

where the challenge is not to remedy design flaws but where the design is the flaw. Attempts at scaling up and expanding these carbon trading schemes to additional sectors, such as the forest and land use sector (where error margins are even bigger and risk of reversal of carbon savings is significant), and linking trading schemes that operate in jurisdictions where enforcement capacity differs significantly, will provide the ground of trading in ‘subprime’ carbon derivatives, in particular given that much of the trading activity in carbon offsets is carried out in over-the-counter trading.

Comment on some of the specific questions the CFTC is seeking input on:

1. *Section 750 of the Dodd Frank 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?*

One characteristic that sets the carbon market aside from commodity markets is that the carbon market has been created through legislation – essentially, the Kyoto Protocol and the national / EU trading schemes. The policy objective of the carbon market has been defined in this legislation as contributing to reducing greenhouse gas emissions at low cost. The creation of the carbon market was thus linked explicitly to an environmental objective. If the environmental integrity of the underlying asset of carbon derivatives and spot trading cannot be verified consistently, regulation cannot ensure the regulatory objective of the carbon market’s environmental effectiveness is achieved.

Thus, assessing whether the environmental effectiveness of the carbon markets in mixed permit /offset carbon trading schemes can be ensured ought to be one of the principal questions to be explored. In addition, FERN believes a careful exploration of the additional regulatory challenges and obstacles of including sectors with considerably bigger methodological uncertainties, such as the land use, agriculture and forestry sector, into carbon trading schemes designed to allow the trade in fossil fuel based carbon permits, is crucial to assess the impact of such inclusion on the regulatability of carbon markets.<sup>2</sup>

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.?*

First, we would like to re-iterate that in a cap-and-trade scheme, it is the ‘cap’ which determines the environmental integrity of the scheme, while the ‘trade’ component is only a cost management tool, which itself does not reduce emissions. The design of the trading component thus will affect (a) the extent to which the trading scheme helps entities covered by the scheme achieve mandated emissions reductions in a cost-effective manner and indicate (b) whether law makers interpreted cost-effectiveness mainly from the perspective of short-term

---

<sup>2</sup> See among others: M.Jonas: ‘Understanding the Carbon Balance’ and ‘Interim summary: Ignorance of terrestrial versus fossil carbon fluxes’ Power point Presentation IIASA 10 June 2008

savings for the covered entities or look at the ‘cost’ of reducing emissions from the perspective of society at large and the ‘cost’ of not averting runaway climate change.

The EUETS included design flaws two levels that meant it was designed with the objective of reducing short-term costs of compliance rather than establishing a ‘price of carbon’ that would trigger transformational investment in low carbon energy infrastructure. First, the EUETS allowed for free allocation of carbon permits to covered industries, included provisions that allow companies to bank unused allowances for future phases of the scheme and resulted in an over-allocation of permits. These factors resulted in low and volatile carbon prices under the EU ETS to date. Virtually all existing and planned carbon trading schemes have opted to repeat these ‘mistakes’. Second, the EU ETS design has introduced a hole into the cap in the form of carbon offsets. Offsets are inherently prone to fraud because in order to earn carbon credits, a project proponent must demonstrate that the offset project is delivering ‘additional’ emission reductions. The project proponent has to demonstrate that without offset revenue, the claimed emission reductions would not have happened. Offset project documentation also must estimate how many emissions would have occurred without the project in order to determine how many emissions were avoided. In the words of the US Government Accountability Office, “Because additionality is based on projections of what would have occurred in the absence of the CDM, which are necessarily hypothetical, it is impossible to know with certainty whether any given project is additional.”<sup>3</sup> Therefore, it is very easy for offset project proponents to overestimate reductions claimed in their stories, or even commit outright fraud. According to Transparency International, the Clean Development Mechanism’s Executive Board has already found problems with “attempts of falsification of documents by project participants and information on financial statements.”<sup>4</sup> FERN analysis and case research has equally documented such cases of fraud and exaggeration of reduction claims, among other serious environmental and sustainable development shortcomings of registered offset projects.<sup>5</sup>

Moreover, the process of offset verification and crediting is characterized by conflicts of interest and corruption risks. For example, project developers pay external consultants to verify the emissions reductions from their project. These verifiers may also offer project development consulting services, posing conflict of interest dynamics that mirror those involving credit rating agencies and their clients; and financial auditors who also provide management consulting services. Several CDM accredited auditors have already been suspended for poor quality of their assessments.<sup>6</sup>

---

<sup>3</sup> Testimony of John Stephenson, Director of Natural Resources & Environment, Government Accountability Office, before the Subcommittee on Energy and Environment, Committee on Energy and Commerce, House of Representatives, March 5, 2009 at <http://www.gao.gov/new.items/d09456t.pdf>

<sup>4</sup> UNFCCC Executive Board of the CDM, Thirty-Seventh Meeting report, February 2008 at <http://cdm.unfccc.int/EB/037/eb37rep.pdf>

<sup>5</sup> See case studies referenced in ‘Jutta Kill et al., *Trading Carbon: How it works and why it is controversial*, FERN, August 2010 <http://www.fern.org/tradingcarbon> ; further evidence available on request

<sup>6</sup> Among the auditors suspended by the CDM Executive Board were the CDM’s largest auditing firm, DNV – Det Norske Veritas, and SGS.

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 high-profile trading scandals (carousel fraud and allowance theft from registries) that have plagued the EU ETS have occurred in the spot market.<sup>7</sup> This is in part due to the fact that spot trades in the EU are subject to Value Added Tax (VAT), while derivatives are not, opening up numerous opportunities for fraudsters (VAT fraud is easier to commit with carbon than with physical imports as no storage or transport is required). While exact losses remain elusive, Europol estimates that in just 18 months, VAT carousel fraud resulted in the loss of over €5 billion to treasuries of EU Member States. Europol further estimated that “in some countries, up to 90% of the whole market volume was caused by fraudulent activities.”<sup>8</sup> Allowance theft (such as the 1.6 million EUAs that were stolen in November 2010 from a cement manufacturer’s account in the Romanian emissions registry) has occurred because of electronic hacking and phishing activities. Thieves usually try to quickly trade stolen carbon through various accounts and different countries before putting them on a spot exchange, in hopes of quickly dispensing of them. Questions of ownership once the final buyer of stolen permits has been located (the permits have individual tracking numbers) remain unresolved and different jurisdictions within the EU view the matter differently, adding to the complications of resolving the legal questions arising from such theft.

While the high-profile scandals with EUETS permits have hit the spot markets, the risk of fraudulent trading with carbon derivatives, especially with derivatives of carbon offset credits, is significant.

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

Regulatory arbitrage is already a problem even in the relatively uniform regulatory framework of the EU ETS. For example, in November 2010, a surge in “suspicious” trading activity on the Italian GME exchange (where volumes on the spot market exceeded those on the futures market, and carbon traded at a discount for weeks) seemed to be the result of fraudsters switching their activities from Denmark, then Spain to Italy, one of the few countries that still has not implemented ‘reverse-charge’ for VAT.<sup>9</sup> Regulatory coordination among the EU member States has also been a challenge in relation to an earlier VAT scandal, with the Danish EUETS register at the heart of the fraud; reportedly France and Germany refused to give Danish authorities, who were pursuing VAT fraud, access to trading accounts on grounds of data protection.

<sup>7</sup> <http://ekstrabladet.dk/kup/dinepenge/article1472518.ece>

<sup>8</sup> “Carbon Credit fraud causes more than 5 billion euros damage for European Taxpayer” Europol press release, 9 Dec 09 at <http://www.europol.europa.eu/index.asp?page=news&news=pr091209.htm>

<sup>9</sup> “Traders suspect VAT fraud in Italy as volumes surge,” ICIS Heren, Nov 26, 2010 at

<http://www.icis.com/heren/articles/2010/11/26/9414464/emissions/edcm/traders-suspect-vat-fraud-in-italy-as-volumes-surge.html>