

X-pand into the Future



Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

January 6, 2010

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

Dear Mr. Stawick:

Eurex Deutschland, one of the world's leading derivatives exchange, welcomes this opportunity to provide input on the Commodity Futures Trading Commission's ("CFTC" or "Commission") study on carbon markets.¹

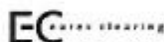
Eurex Deutschland is a futures and options exchange operated by Eurex Frankfurt AG (hereinafter "Eurex Deutschland" and "Eurex Frankfurt AG" together are referred to as "Eurex"). Eurex offers a broad range of international benchmark products and operates some of the most liquid fixed income markets in the world, featuring open and low-cost electronic access. With some 418 market participants connected from 700 locations in 25 countries, trading volume at Eurex exceeds 1,5 billion contracts a year. Eurex currently counts 69 members as U.S. resident entities.

Eurex has been a prominent fixture on the U.S. financial markets landscape for nearly fifteen years. In 1996, Eurex's predecessor entity, Deutsche Terminbörse GmbH ("DTB"), received the first no-action letter from the CFTC allowing a Foreign Board of Trade ("FBOT") to install trading screens in the U.S. without an additional registration as a board of trade with the Commission. This was the first of many such no-action letters that foreign exchanges have received from the CFTC. In 1999, the DTB no-action letter was reissued to Eurex and the scope of relief therein expanded.²

Please see below for Eurex's comments on several of the Commission's questions.

¹ *Public Input for the Study Regarding the Oversight of Existing and Prospective Carbon Markets, Notice and request for comment: 75 FR 72816, November 26, 2010, (the "Notice").*

² See Commission Staff Letter No. 99-48, http://www.cftc.gov/tm/letters/99letters/lmeurex_no-action.htm.



Eurex Clearing AG
Mergenthalerallee 61
65760 Eschborn

Mailing address: Internet:
60485 Frankfurt/Main www.eurexclearing.com

Chairman of the
Supervisory Board:
Prof. Dr. Peter Gomez

Executive Board
Andreas Preuß (CEO),
Jürg Spilmann, Thomas Book,
Gary Keltz, Michael Peters,
Peter Reitz

Aktiengesellschaft mit
Sitz in Frankfurt/Main
HRB Nr. 44828
Amtsgericht
Frankfurt/Main

1. Section 750 of the Dodd-Frank indicates that the 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?

Regulatory oversight should extend also to assuring that the purposes of carbon regulation are furthered by market operations i.e. that trading in emission rights contribute to the reduction of greenhouse gas Emissions.

2. What are the basic economic features that might be incorporated in a carbon market that would have an effect on 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.?

Characteristics of Allowances:

The underlying instrument of the European Union ("EU") Emission Trading System ("ETS") is the European Union Allowance ("EUA") – a fully fungible and tradable permit to emit one ton of CO₂ equivalent. EUA are issued by the European Commission respectively the European Member States and are valid for a certain compliance period, i.e. their lifetime spans from issuance to the presentation for demonstrating compliance.³ Economically, holding EUA does not yield any interest or dividend during their lifetime. Returns from holding EUA are realized either when they are presented for compliance or are sold for a market price. Hence, the rationale for buying, selling and holding EUA in advance of the respective compliance date would be to manage price risk – in particular, to mitigate the risk of severe supply shortages before the compliance date. At the same time, running an inventory of EUA in advance to the respective compliance deadlines implies an opportunity cost for the foregone interest on the capital locked up.

Allowances should be designed so they can be easily auctioned in the primary market and easily traded in the secondary market. By limiting the scope of auctioned products to instruments commonly traded in liquid secondary markets, the risk of fragmenting liquidity between primary and secondary markets is minimized.

Allocations:

Most cap-and-trade regimes start off with free allocations to emitters subject to the cap. Allocations are either based on their historical emissions (also known as "grandfathering"), or hypothetical emissions derived from efficiency factors (also known as "benchmarking"). For example, Article 10 of the EU Directive (EC, 2003) leading to the establishment of the EU ETS in 2005 specified for the period 2005-2007 at least 95% of the allowances should be allocated free of charge and at least 90% for the current period 2008-2012. The energy industry is the largest sector in the scheme, responsible for more than half of total covered emissions (Christiansen, Arvanitakis, Tangen and Hasselknippe, 2005).

Free primary market allocations is somewhat controversial because electricity producers partly pass on for costing purposes the market value of freely obtained emission allowances to electricity consumers (Neuhoff et al., 2006; Elleman and Buchner, 2006). Emission allowances are supposed to be scarce and, hence, valuable assets with a traded market price – no matter how they are initially allocated. Whether the emission allowances had been purchased for a price or received for free, the owner of the marginal electricity generation plant is always facing the choice between generating electricity (thus incurring the fuel cost and disposing the respective amount of allowances) and not generating electricity (and instead selling both the fuel and the allowances in the respective markets for a competitive price). So, in either case the opportunity cost of disposing

³ To supervise the commitment of the objectives, the European Community has established that each Member State must submit a report of the verified emissions in a given year by March 31 of the following year. For example, the Member States must submit a report of verified emissions in 2009 by March 31, 2010. In that report, compliance of emissions of each company covered by the directive must be specified. Additionally, these companies must surrender the allowances of a given year not later than April 30 of the following year. That is to say, April 30, 2010 is the deadline to surrender the allowances for 2009.

allowances for production is the same.⁴ Therefore, it is economically rational for the electricity generator to either pass-through the opportunity cost of allowances disposed in the wholesale and retail electricity price or to sell the allowances into the secondary trading market for a competitive price.

During the initial two trading phases of the EU ETS, the practice of freely allocating emission allowances led to massive windfall profits for the electricity sector.⁵ Windfall profits should not be confused with profits arising from over-allocation, meaning that certain industry sectors get more allowances than they need, solely from leniency in the setting of emission targets for certain industry sectors. Provided there is sufficient demand, companies from these sectors can sell the over-allocation for cash in the market. In contrast, windfall profits arise solely from the primary market allocation method.

However, windfall and sector specific over-allocation profits are intertwined. With stringent targets, electricity producers will still realize windfall profits because higher market prices for scarcer allowances imply higher opportunity costs to be passed on. Therefore, a more stringent emission cap does not necessarily reduce the size of the windfall profits, but might even increase those profits. Accordingly, if there is systematic over-allocation to some industry sectors, profits from over-allocation could also rise with more stringent caps. Sector specific over-allocation should not be confused with an ultimately loose cap, i.e. an economy wide over-allocation. In this case, over-allocation in principle should lead to a low – or zero – carbon price, resulting in low – or zero – windfall profits. This occurred, for example, in the EU ETS during 2007 after data on over-allocation had been published.

Beyond windfall and over-allocation profits, free allocations bring about additional social costs and adverse dynamics – no matter whether grandfathering or benchmarking is applied. Free allocations inevitably result in rent-seeking behavior by companies and industry organizations as they invest significant time and resources in lobbying for generous allocations. On the other hand, drawing allocation plans is undoubtedly time-consuming and costly for government authorities. Moreover, it is also a risk that the target level of allocations is completely loose, as evidenced, for example, in the EU ETS during 2007. All of this has resulted in a more or less consensual approach within Member States to allocate relatively stringent emission ceilings to the electricity sector for the period 2008-2012. But for the period after 2012, the European Commission proposed to auction off all allowances to the electricity industry. An exemption was made for existing power generators in primarily Eastern European Member States, where the auctioning rate must be at least 30% in 2013 and 100% in 2020 (EC, 2009a).

Auctioning of allowances appears to be the silver bullet for primary market allocations,⁶ although many practical experiences with public and private auctioning demonstrate that even minor design imperfections can have significant adverse effects on the results (Milgrom, 2004; Klemperer, 2004).⁷ Real world auctioning design needs to tackle issues ranging from bidder accreditation, auction integrity, information asymmetries, transaction cost to market abuse and collusion.

⁴ Varian (2003), for example, emphasizes the point that in economics, the concept of opportunity cost must be taken into account whenever a resource can be used in alternative ways. See also Grafton and Devlin (1996) and Nentjes et al. (1995).

⁵ For example, according to IPA (2005) electricity producers in the UK are estimated to have made £ 800 million in windfall profits within the initial phases.

⁶ Please note that there is indeed the alternative for governments to directly sell emission allowances into the market on a discretionary basis. This approach has been taken in Germany in 2008 and 2009 of the second trading phase of the EU ETS. 10% of the total amount of allowances was sold by state-owned bank Kreditanstalt fuer Wiederaufbau (KfW). The remaining 90% were subject to free allocations. In principle, this approach proved to be reasonable when volumes to sell are small compared to daily trading volumes. However, Germany moved from direct selling to auctioning for the remaining years 2010 and 2011 of the second trading phase.

⁷ See also Van Damme (2002) for a discussion of the differing designs and results of European UMETS auctioning.

When organizing primary allocation auctions there are great benefits from reusing existing secondary market infrastructure to the broadest extent possible thereby meeting the requirement for economic efficiency and minimal implementation risk. Running auctions on existing secondary market infrastructure facilitates putting primary market auctioning and secondary market trading under a common regulatory and supervisory framework, avoids the duplication of existing market infrastructure and networks already in place, and minimizes and controls platform and operations costs.⁶

Deleted: ¶

Banking of Allowances:

The issue of whether to allow emissions allowances to be banked was the cause of a major market disruption in October 2006. At that time, EU Member States confirmed there would be no banking of emissions allowances from the first to the second compliance phase. This created a discontinuity in supply of emissions allowances between the phases. Combined with an announcement of stricter second phase allocations, the pricing of futures contracts between the distinct trading periods as well as between first phase spot prices and second phase futures prices became completely disconnected. Owing to the over-allocation, contracts with maturities in the first phase declined towards zero and finally settled at the end of the compliance period in December 2007 at a price of €0.01. In contrast, contracts with maturities in the second phase increased to €20. By December 2007 they traded at a €25 level.

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.

Spot and derivatives markets should fall under the jurisdiction of a regulatory authority. In both the spot and derivatives markets, transactions target the physical delivery of emission allowances. Therefore, rules similar to those in the Markets in Financial Instruments Directive ("MIFID") that currently apply to exchange traded carbon derivatives should be extended for spot trading markets as well.

5. What regulatory methods or tools would be appropriate to achieve the desired regulatory objectives?

A market abuse framework adapted to the carbon market is a necessary tool to achieve the desired regulatory objectives and should cover both the spot and derivatives carbon markets. Such a framework should govern the use of data where there is a significant information asymmetry that a player could benefit from at the expense of others. On the carbon market, as for others commodities markets, it appears relevant to distinguish privileged information, as defined by financial regulation, and sensitive information. For example, there should be a strict ban on the use of regulatory information or aggregate emissions data prior to publication. On the other hand, banning the use of a given participant's own business activities and / or requiring disclosure of such information raise issues of confidentiality and fair competition. In the formulation of such rules, the respective regulatory bodies should weigh the likelihood of the information having a significant impact on emission allowance prices against confidentiality concerns.

⁶ The fast and smooth introduction of on-exchange spot and futures auctioning in Germany was provided as an example of re-usage of existing market infrastructure for primary auctioning purposes. From adoption of the legislation end of May 2009 it took just seven months to select the auctioning venue, build the functionality and getting started beginning of January 2010. In January 2010, Germany auctioned a total of 3.48 million t at the European Energy Exchange (EEX) resulting in proceeds of € 45.4 million. The German government, via state-owned bank KfW, auctions 300,000 spot allowances every Tuesday and 570,000 allowances for December 2010 delivery every Wednesday. Germany's national allocation plan calls for the sale of 40 million t a year already throughout the second trading period 2008-2012. Refer to www.dehst.de for the periodic reporting on Germany's auctioning regime. See also websites of the involved exchanges at www.eex.com and at www.eurexchange.com.

6. What types of data or information should be required of market participants in order to allow adequate oversight of a carbon market? Should reporting requirements differ for separate types of market participants?

Emission data are only disclosed once a year upon compliance and verification. When these disclosures are made at such low frequency, there is risk of shocks to the market equilibrium. Low frequency of disclosures by market participants is detrimental to the robustness of the market and increases the risk insiders will trade on information not publicly available. Therefore, carbon markets would benefit from higher frequency disclosure. One possibility to improve transparency requires the largest emitters to report emission levels at least quarterly, although these interim reports would be subject to lighter verification rules⁹ in order to keep down costs and published in an aggregated format (by industrial sector and by country) to maintain confidentiality of individual participant's data.

Reporting of trade data should be done through the systems of exchanges, clearing organizations, trade repositories or brokers. These systems could allow regulators to access relevant data if necessary, without imposing a significant burden on individual firms and while maintaining confidentiality. Position reporting of large positions should be handled in a similar matter.

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 in the derivatives markets?

In the EU, the spot market and most of the over-the-counter derivatives markets are not covered by regulations or supervision by European authorities, since these products are not considered to be markets in financial instruments, however exchange-traded derivatives on emission allowances are covered by the MIFID and the Market Abuse Directive ("MAD"). This creates a fragmented market for emission allowances, leading to questions regarding the efficiency of the markets and whether market participants are adequately protected from fraud and other abuses.

In contrast to commodities markets, where issues surrounding various physical assets must be addressed, the only difference between a spot contract and derivative contract in the carbon markets are the date of delivery and that derivatives are used for hedging. In a sense, there is a continuum between the spot and derivatives markets, the only difference being the delivery date. Because the spot and derivatives markets are so similar to each other, any fragmentation between the two reduces the efficiency of the price discovery process in carbon markets.

To the extent unified regulatory oversight is not practicable, care should be taken to avoid overlaps or conflicts in jurisdictional authority.

⁹ Although not subject to audit, reporting market participants could be held accountable for the information they report by being subject to a "best possible efforts" standard.

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?

Eurex strongly encourages the CFTC to coordinate its oversight of carbon markets with those in other countries, especially member states of the European Union which has sophisticated, well-regarded market operations. Since global emissions, as well as the limits on them, are a global problem the markets for them will attract global participation. Global participation with numerous national and regional regulations is accompanied by the risk of regulatory arbitrage which might seriously hamper the effectiveness of the markets.

9. What has been the experience of state regulators in overseeing trading in the regional carbon markets and how would that instruct the design of a federal oversight program?

The European Commission considers that the number of markets in which to trade the European Union Allowances should be appropriate from the point of view of the agents participating in them. This means that each country can create its own market or that different private trading platforms can be organized. So, although there is a sole European emissions market, trading can be done through different markets around Europe. In all markets the underlying asset is the EUA but the spot and futures contracts that can be traded are slightly different. Pricing relations between the different venues suggest that this approach did not hamper efficient and transparent price discovery. Price differentials can, in general, be explained by differences in contract design and in post trade processing.

11. Who are the primary participants in the current primary environmental markets? Who are the primary participants in the current secondary allowance and derivatives environmental markets?

The power / energy sector represents about 40% of total emissions covered by the ETS.

When EU emissions allowances became a tradable but risky asset, a variety of risk management and funding instruments was made available to the market. This attracted financial intermediaries in their multiple capacities ranging from funding and brokerage services to market making and derivatives structuring. It also pulled institutional investors seeking alternative risk taking and investment opportunities. Both the financial intermediaries and the institutional investors are common and major constituents to global and regional energy markets. By exploiting temporary market disequilibria and arbitrage opportunities across markets, they ensure efficient price discovery and implicit co-integration of energy and emissions markets.

It is inevitable that the diversity of institutions and enterprises exposed to emissions markets under the EU ETS creates demands for trading instruments other than the underlying emissions allowances themselves. There is active trading in derivatives along the forward-curve to meet the energy markets' demand for long-term risk management tools. The legitimate fundamental economic functions of derivatives markets are price discovery and the transfer of risk from those exposed to it but who do not want to bear it (i.e. hedgers) to those not naturally exposed to it but willing to bear it (i.e. speculators). Intermediaries support these functions by structuring tailored instruments and by providing liquidity to the markets.

As it is the case for most other energy markets there is fierce competition on pricing as well as on product innovation between exchanges but also between exchanges and Inter-Dealer-Brokers ("IDB") to attract trading flows. In fact, off-exchange trading in exchange-listed and centrally cleared futures dominated by far the early days of futures trading under the EU ETS.

Horizontally, the current market architecture of the EU ETS spans from regulated exchange markets to IDB venues. Almost all of the exchanges launched emissions trading as an add-on to

their market presence in other product classes in the energy markets – particularly to electricity trading. In this respect, the IDB venues are the most diversified. They essentially offer any product class from oil, coal, gas, electricity, freight to emissions. In contrast to exchanges they also arrange trades in bespoke and structured instruments.

Vertically, the current market architecture covers the whole value chain spanning from trading to clearing and, finally, to settlement and account keeping. Again, most of the entities offer multiple product classes and, hence, can offer cost-efficient transacting across product classes. Clearinghouse services are offered for futures and options only but not for structured instruments.

Eurex thanks you for your attention to our concerns. If you have any questions please do not hesitate to contact us or Mr. Vassilis Vergotis, Head of US Offices (312-544-1058; vassilis.vergotis@eurexchange.com).

Yours faithfully,



Peter Reitz

Member of the Executive Board