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## 'The Emissions Trading Market: Risks and Challenges'

### A Report by the FSA's Commodities Group

In March 2008, the FSA's Commodities Group published a report, "The emissions trading market: risks and challenges" as a follow up to its 2007 paper, "Growth in commodity investment: risks and challenges for commodity market participants". The report discusses the emissions trading market's main areas of risk, how to mitigate them, and the role of the FSA in the market.

The emissions trading market has developed as a result of political initiatives, such as the Kyoto Protocol<sup>1</sup>, to combat climate change. It focuses on the trading of carbon dioxide (or carbon dioxide equivalents) and is run on a 'cap and trade' basis, which means that each year the government or relevant body of each participating country sets a cap on the amount of CO<sub>2</sub> certain energy intensive businesses and industries in that country are allowed to emit that year. It then auctions a number of allowances (1 allowance = one tonne of CO<sub>2</sub>) to those businesses and industries or it issues them for free. If a business does not use up its share of allowances within the year, it can either keep them for the following year or sell them on the market. If a business exceeds its share of allowances, it has to buy more or pay a fine.

The FSA does not regulate the underlying emissions market. Its responsibilities instead relate to the emissions derivatives market. However, the FSA still has an interest in the underlying market as any risks that spill over into the derivatives market will potentially affect it.

The report's key findings are:

- The emissions market is small compared to established commodity markets, but it is growing rapidly and is expected to expand significantly in the near future, particularly by including the aviation, shipping and chemicals industries, and by encouraging a greater number of countries to participate.
- There are an increasing number of trade venues, due in part to the success of certain trading schemes, such as the EU Emissions Trading Scheme<sup>2</sup>.

- The market has a strong interaction with the power, gas, coal, oil and freight markets, and has the potential to become the largest commodities market.
- Institutional investment is minimal, due to factors such as the relative immaturity and high volatility of the market. Direct involvement in the traded commodity market by consumers is also very limited, as they tend to use Voluntary Emission Reductions (VERs), which are not investment products, to lower their carbon footprint<sup>3</sup>.
- Because the market is new and is growing so quickly, there is a lack of experienced staff available to authorised firms.
- The short market trading history means that there are few risk management tools in place.

The report states that the key areas of risk (though not all exclusive to the emissions trading market) are:

- Market foundation:
  - There must be a set of common standards and improved communication between different commodities markets.
  - There must also be efficient management of the allocation of allowances so that there is no over or under allocation. During the first phase of the EU Emissions Trading Scheme, over allocation of allowances greatly reduced their value so that, according to some, the market was meaningless.
- Market integrity:
  - The high profile of combating climate change, as well as the kudos attached to 'carbon

<sup>1</sup> The Kyoto Protocol was drawn up in 1997 and has been ratified by 175 countries. Under the Protocol, during the period 2008-2012, developed countries should aim to reduce their emissions levels to approximately 5% below their 1990 levels.

<sup>2</sup> The EU Emissions Trading Scheme is the world's largest emissions trading scheme, and is used by the EU to meet its Kyoto Protocol targets (which it signed up to as a single body). It focuses on energy intensive industries and is split into 3 phases: 2005-2007, 2008-2012 and 2013-2020.

<sup>3</sup> VERs are used by businesses that want to be carbon neutral but are not covered by the scope of the EU Emissions Trading Scheme. However, the lack of a regulatory body lowers their credibility.

friendly' businesses means that many companies want to be seen as associated with the emissions trading market.

- This can lead to exploitation by companies that may take advantage of the positive association by offering services or products with only a tenuous link to preventing climate change. This is particularly relevant to the VERs market.
- FSA authorised companies may also mislead consumers by claiming that the FSA endorses carbon reduction activities that it does not actually regulate.
- Market infancy:
  - The short history of the market means that there is a lack of staff with appropriate experience.
  - Staff with relevant experience must be recruited, trained and retained. Adequate risk management systems must also be put in place.
- Information Risk:
  - Transparency is vital. Any information released must be done so in an orderly and timely manner.
  - Some people say that there should be a more regular release of information than at present.
- Market Abuse:
  - The emissions market is no more susceptible to abuse than the other commodities markets.

- Liquidity
  - Although liquidity is generally good, it is important to ensure that the proliferation of new trading venues does not cause fragmentation.

The report concludes that the emissions trading market is fairly similar to the other commodities trading markets, the only major difference being its political links. It says that the FSA should continue to monitor the market's risk areas, but that it does not need to assume any further responsibilities as, despite a few initial problems, the market is now functioning well.

The fight against climate change is certainly gaining prominence. As well as the EU Emissions Trading Scheme, other major environmental initiatives include the Climate Change Bill, which had its third reading in March 2008 and the Carbon Reduction Commitment, an emissions trading scheme for large non-energy intensive businesses in the UK, introduced through the Climate Change Bill, which will come into force in 2010. A report by Point Carbon<sup>4</sup> from March 2008 put the value of global carbon markets in 2007 at €40 billion, up by 80% from 2006, making emissions trading potentially a future leading part of the derivatives market. The FSA's Commodities Group has acknowledged this and has recognised that because emissions trading is a developing area, it is important that financial regulation of this area is kept under review and develops accordingly.

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<sup>4</sup> <http://www.pointcarbon.com/research/carbonmarketresearch/analyst/1.912721>

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