– Consultation Response –

Europex response to IOSCO Compliance Carbon markets Consultation Report

Brussels, 10 February 2023 | Europex welcomes the opportunity to provide feedback to IOSCO's consultation on compliance carbon markets. Carbon markets play a key role in facilitating decarbonisation at least cost and ensure a high level of competition and innovation. Against this background, we provide our assessment of the recommendations to strengthen these markets below.

Question 1: What are the benefits and risks of linking frameworks? How can these benefits be enhanced and these risks be mitigated?

There are clear benefits to having an increased scope of economic activity captured under a single ETS. A larger underlying supply of allowances and wide sectoral coverage in a single jurisdiction will likely lead to increased trading activity and improved market liquidity which, in turn, will produce the most reliable carbon price and cost-effective abatement. The same benefits extend to linking two or more ETSs.

Naturally, there are also challenges to achieve linkages which should be taken into consideration. To link different jurisdictions, governing bodies need to surrender some control over their systems. Since linked ETSs need to be aligned to a certain extent, the linked jurisdictions need to jointly agree on the rules applicable.

Question 2: What should be the conditions underpinning a decision to link frameworks?

The linkage of different frameworks requires robust political support. Jurisdictions must accept the need to share control over the ETS at the benefit of having a larger, more robust carbon market. Moreover, a linked ETS needs to be largely aligned on fundamental aspects of its design in terms of scope and ambition level.

For example, the EU and UK systems should be most convenient to link given their technical parallels, overlap of market participants and similar environmental ambition of the two jurisdictions. Whilst we welcome the 'serious consideration' to linking given in the Trade and Cooperation Agreement (TCA), this potential has yet to transpire concretely.

Question 3: Do you agree these IOSCO principles are appropriate for carbon markets? Explain your response.

Overall, Europex is supportive of IOSCO's principles-based approach and encourages global coordination on establishing sound oversight frameworks for carbon markets. The principles highlighted in the consultation paper are relevant to this purpose and have proven effective when applicable to, for example, commodity markets. In addition, it should be noted that in certain key jurisdictions such as the EU, many of those principles are already being applied to both the primary and secondary compliance carbon market. This well-established oversight and trust provided through trading allowances on regulated exchanges has contributed to the success and trust that the EU ETS currently enjoys as the largest scheme of its kind.

However, we encourage regulators to be mindful of the specific characteristics of these markets and their interplay with existing regulation when designing and applying an appropriate regulatory framework. While we indeed agree that several of the principles highlighted in the consultation paper provide important lessons learned also for these new(er) markets, carbon markets have certain bespoke characteristics which distinguishes them from other (commodity) derivatives markets.

Question 4: Are other IOSCO principles relevant for application to these markets?

Europex has not identified any other IOSCO principle that should be applied to carbon markets and cautions against applying a recommendation that has not been tailored to the specific nature of carbon markets.

Question 5: Do you agree the rules currently in place across key jurisdictions are helpful for scaling of carbon markets?

In general terms, the level of transparency and oversight arrangements currently in place in some of the key jurisdictions such as the EU have proven to be important for increasing trust and participation in these markets and contributed to their success. Just recently, EU institutions backed a proposal to significantly strengthen and expand the EU ETS which has been widely applauded. However, this example also indicates how the scope of a compliance carbon market is per definition static until there is political will to increase the scope of the ETS by covering new sectors or operators.

Question 6: Are there any other aspects of compliance markets that could benefit from regulatory oversight?

Europex is not aware of any specific aspects in relation to the oversight of EU, US or UK carbon markets that requires improvement. Rather, we encourage regulators to enhance the efficiency of the existing regulatory frameworks and work to reduce barriers to facilitate potential forms of further cooperation such as linking.

Question 7: Are the recommendations appropriate for the compliance markets?

Europex largely supports the recommendations for the ISOCO carbon compliance markets. Please find below Europex' views on the individual recommendations.

<u>Recommendation 1:</u> Europex supports the recommendation. Any changes to an ETS, including those that may impact secondary markets, should ideally be announced well in advance and be consulted upon by the market stakeholders.

The governing body of an ETS can, for example, change the supply of allowances without negatively impacting price formation on primary or secondary carbon markets by announcing such changes in advance and aligning with a (science-based, Paris-aligned) policy goal.

<u>Recommendation 2:</u> Europex supports the recommendation. Auctioning is the default allocation method for allowances in the EU ETS. It is the most transparent allocation method that provides a harmonised and non-discriminatory process. The principle of auctioning with the intent to gradually move to full auctioning is fundamental to the objective of emissions trading as it guarantees that the costs of carbon are internalised. To this end, more ambitious climate targets should be used as an opportunity to increase the share of allowances auctioned and decrease the allocation of free allowances. A linear and continuous increase of the auctioning share would provide the greatest possible predictability for market participants.

<u>Recommendation 3:</u> As stated above, Europex strongly supports auctions as the default allocation method of allowances within compliance carbon markets. While frequency may have certain benefits as indicated in the consultation paper, the appropriate quantity of auctions should be carefully considered in each ETS depending on, for example, the overall cap and minimum volumes per auction.

<u>Recommendation 4:</u> Europex largely supports the recommendation. Should a structural mechanism be deemed necessary in order to, for example, reduce a potential oversupply of allowances, such a mechanism should indeed be rule-based and predictable in nature. In addition, rather than automatically triggering a standard response in predetermined situations, flexibility to take into account the market developments is most appropriate. Such mechanisms are preferred over one-off or politically driven market interventions, which may damage the functioning of carbon markets and, thus, should be avoided.

Furthermore, Europex believes that in such cases, volume-based mechanisms (such as the EU ETS Market Stability Reserve) are preferable to price-based stability mechanisms, as price-based mechanisms interfere with the price discovery process. Europex would contest the notion that volume-based mechanisms would be more prone to manipulation.

Finally, it is important to distinguish between the goals of the mechanisms in place and highlighted in the consultation paper. The goal or intended purpose of a mechanism should foremost be to guide a regulator's assessment and decisions. For example, the EU MSR was put in place to address the oversupply of allowances in the bloc's carbon market. It is a tool to manage changes in supply/demand caused by external circumstances, not a tool to cater to price volatility.

<u>Recommendation 5:</u> Europex strongly supports the recommendation. Please refer to Europex' response to question 8, which further discusses our suggestion to broaden this recommendation to include secondary carbon markets.

<u>Recommendation 6:</u> Europex generally supports the recommendation and would recommend alignment of the legal nature of carbon allowances with carbon credits to facilitate potential integration.

<u>Recommendation 7:</u> Europex generally supports the recommendation. Trustworthy auction performances are a key element of a successful ETS. When regulated exchanges perform this service, the functioning of the auctions is by default extensively analysed and reported upon.

<u>Recommendation 8:</u> Europex supports the recommendation and believes that an effective oversight framework is a key pillar for the continued success of ETSs. In several key jurisdictions, well established compliance and market supervision frameworks are already implemented. However, the introduction of position limits on carbon markets risks unnecessarily restricting their development and could hamper the development of the carbon derivatives market. To this end, Europex warns against imposing position limits on carbon markets.

Moreover, carbon markets have several unique features. In the EU, for example, EUAs are storable and can be used for compliance over several years. In addition, a new supply of EUAs is added to the market almost every working day via the primary auctions. As a result, the total quantity of EUAs in circulation is currently much larger than the total volume of allowances derivatives with expiry in a given year.

Importantly, following a thorough review in March 2022, in its final report on emission allowances and associated derivatives, ESMA concluded that the EUA market functions as expected and did not find sufficient reason to recommend the introduction of position limits. ESMA did, however, recommend a number of potential bespoke improvements to transparency and oversight which includes applying position management controls to carbon markets.

<u>Recommendation 9:</u> Europex agrees with the recommendation. Derivative exchanges promote liquidity, provide price transparency, ensure trading integrity and maintain orderly markets through their rules and well-established compliance and market supervision frameworks.

<u>Recommendation 10:</u> Europex generally agrees with the recommendation. Governments can encourage the development of standardised derivative contracts through legislative frameworks which promote the development of liquid markets, or - in other words - provide the appropriate conditions which allow for secondary carbon derivatives markets to develop. This principally means, for example, allowing the trade in derivative contracts (unlike for

example the Chinese ETS) and allowing financial (non-compliance) entities to participate (unlike for example the Korean ETS).

Recommendation 11: Europex has no fundamental objections to disclosing aggregate positions in the registry. To provide any meaningful insights, the taxonomy of the reports would need to be clear, transparent and easy to understand.

Recommendation 12: Europex generally supports the recommendation but has identified no fundamental concerns that would need to be addressed in the various jurisdictions it is active.

Question 8: Are there any other aspects that the recommendations should address? If so, please state which ones and explain your reasoning.

Europex supports recommendation 5 and suggests broadening it to include secondary markets and the benefits of participation by financial institutions. Recently, a relatively high price for allowances generated political debate in the EU on the functioning of EU carbon markets and the impact of financial participation. Following review by independent EU institutions, including ESMA and the ECB, there was sufficient evidence that the EU carbon market is functioning well, and that financial participation is important to the liquidity and the well-functioning of primary and secondary carbon markets.

In absence of financial participation, firms with compliance obligations may not be able to find a counterparty to take the opposite side of a transaction, leaving them unable to protect themselves against fluctuations in the price of carbon, increasing the risk of insolvency of these energy producers or energy-intensive industrial firms.

About

Europex is a not-for-profit association of European energy exchanges with 32 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

Contact

Europex – Association of European Energy Exchanges
Address: Rue Archimède 44, 1000 Brussels, Belgium
Phone: +32 2 512 34 10
Website: www.europex.org
Email: secretariat@europex.org
Twitter: @Europex_energy