EU Emissions Trading System – Oversight of the European carbon market

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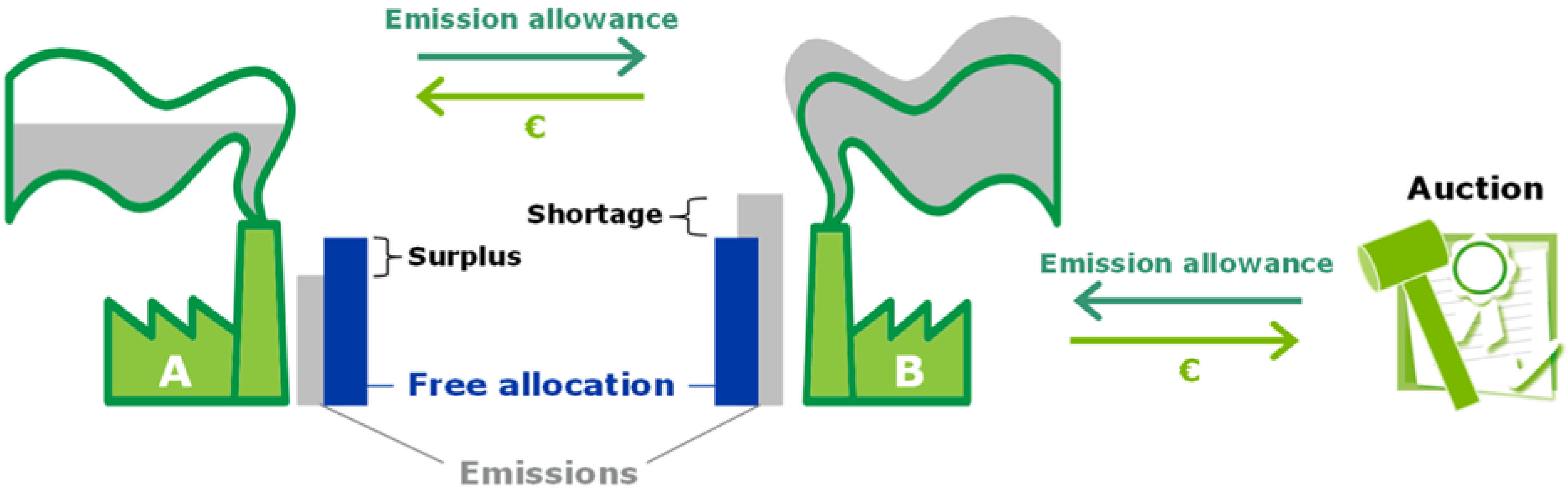
Basic facts about the EU ETS

- ‘Cap and trade’ system that applies to ca 10,000 installations including power, steel, cement, chemicals, paper, refineries and intra-EU aviation
- 30 countries (27 EU Member States + Norway, Iceland and Liechtenstein), covering around 40% of EU's emissions



Evolution of the European carbon market

- The European carbon market has grown substantially since its start in 2005
- Every year, the European Securities and Markets Authority (ESMA), publishes the estimate on the size of different European markets, including the carbon market
- In two years, the value of the market has increased by more than 50%

Year	Exchange-traded derivatives (ETD)	Over-the-counter (OTC)	TOTAL*
2018	451,120	6,087	457,207
2019	563,788	35,137	598,925
2020	653,804	33,739	**687,543**

**Values in million EUR*

Looking closer at the European Carbon Market

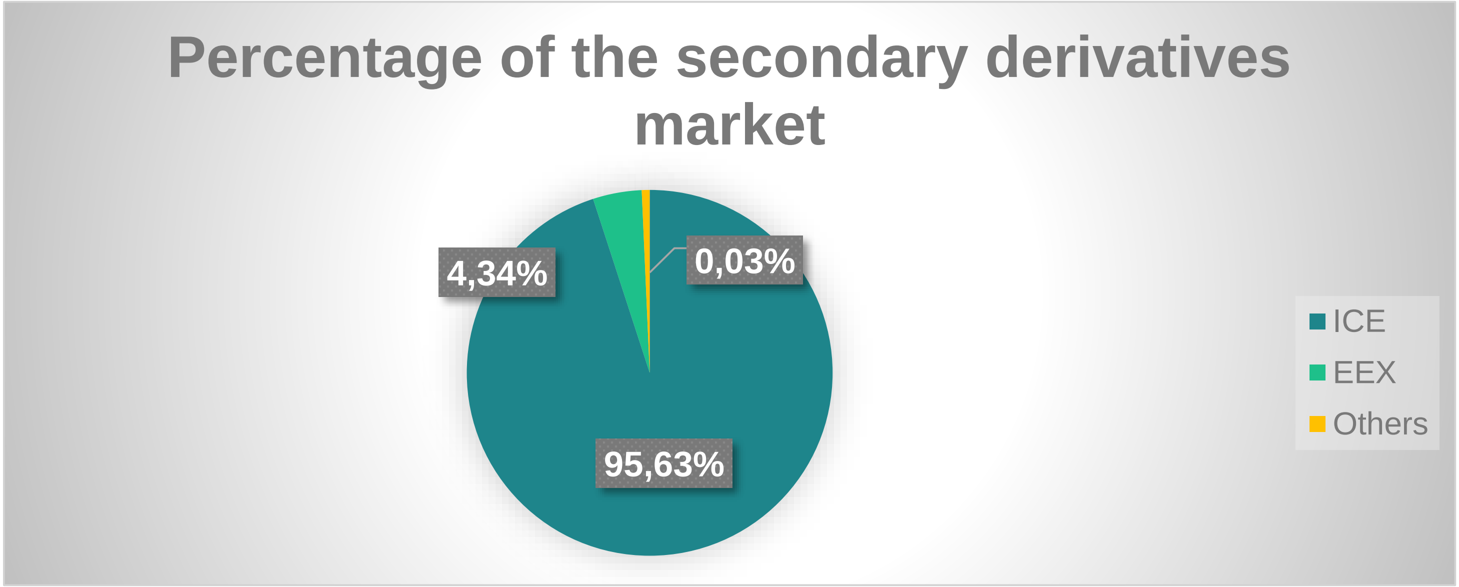
- Emission allowances are traded as:
    - Spot contracts (instant delivery)
    - Derivatives:
        - futures/forwards (benchmark December future contract)
        - options, swaps, spreads, etc.

- Different financial products were developed gradually by the market

- Derivatives play a crucial role as they provide ETS operators with flexible ways to manage their carbon price risk

Looking closer at the European carbon market

- Market is concentrated mainly on two trading venues:
  - ICE Endex, Netherlands (after moving from ICE Futures Europe, England)
  - European Energy Exchange (EEX), Germany



Supply

- Emission allowances are first placed on the market either through auctioning or through free allocation (primary market)
- EEX in Germany is currently performing the services of the auction platform
- Auctions are organised every business day, with around 3 million allowances per auction
- The auction revenues are distributed to the Member States. The total revenues generated from the auctions between 2012 and 30 June 2020 exceeded EUR 57 billion

Demand

- Eligible participants in the auctions are:
  - compliance buyers under the EU ETS (operators)
  - business groupings of compliance buyers
  - investment firms and credit institutions authorised under applicable EU legislation
  - other entities specifically authorized by EU Member States
- Compliance buyers, investment firms and credit institutions are also dominant categories of market participants in the secondary market
- In order to take ‘physical’ possession of allowances, it is necessary to hold an account in the Union Registry of emission allowances

Market oversight framework

- Importance of having an adequate regulatory framework for oversight of both primary and secondary market
- Initially only market oversight rules for auctions and secondary trading in derivative products
- Since 2018, spot emission allowances also classified as financial instruments in Directive on Markets in Financial Instruments (MiFID II)
- Classification means that a number of financial market rules apply to the carbon market

Applicable financial market rules

- **Markets in Financial Instruments Directive and Regulation (MIFID II/MIFIR)**
  - licensing requirements for trading venues and financial intermediaries (investment firms)
  - reporting and transparency requirements to avoid market abuse
  - rules on supervision and cooperation between national competent authorities

- **Market Abuse Regulation**
  - prohibits insider dealing, unlawful disclosure of inside information and market manipulation
  - applies to all market participants, irrespective of whether the abuse takes place in the Union or in a third country

- **Anti-Money Laundering Directive**

Oversight in practice

Primary market (auctions)

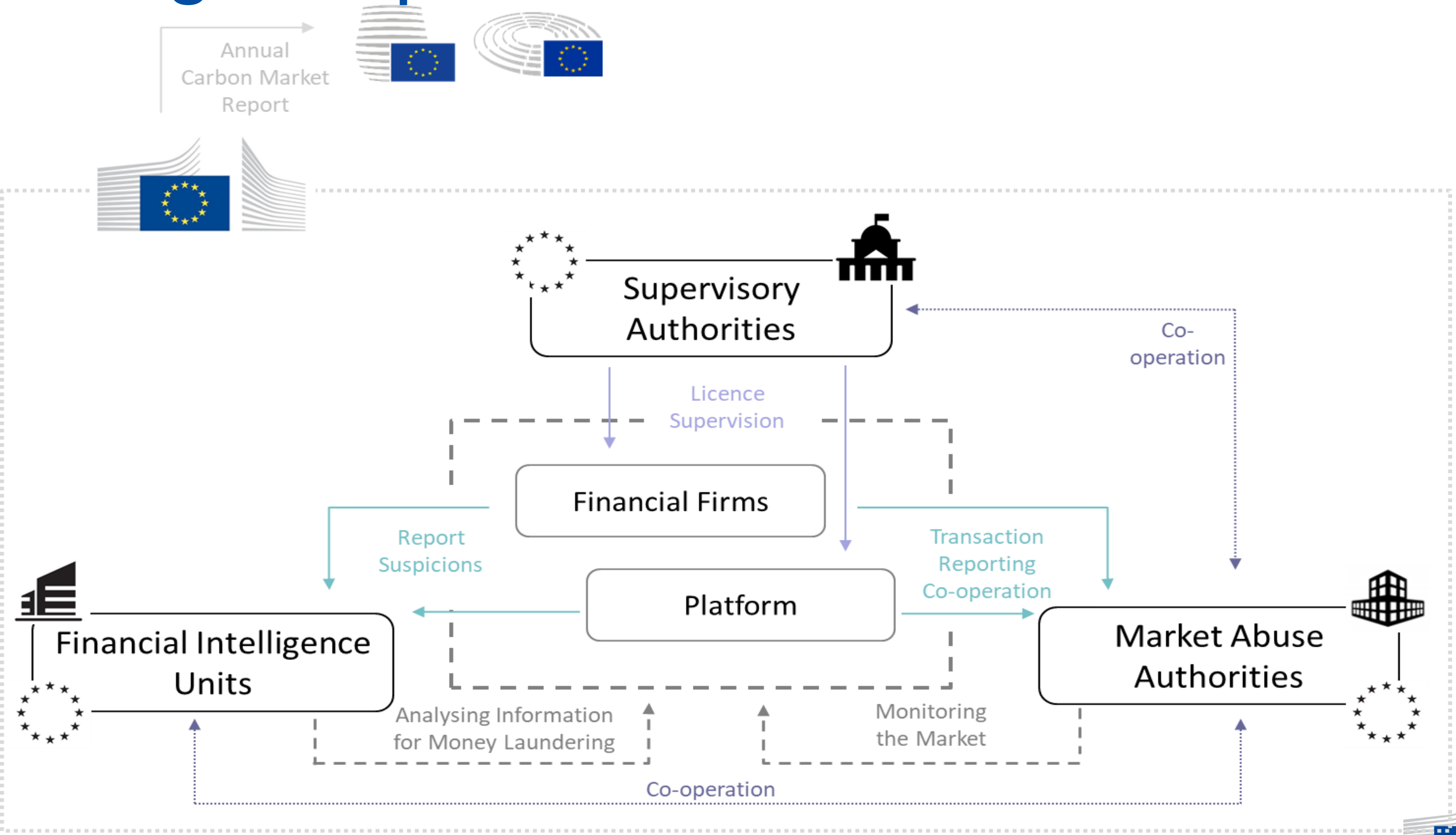
- High frequency of auctions
- Design of the auction (sealed bid, single price procedure with minimum reserve price mechanism)
- Only trustworthy categories of bidders are admitted, possibility of introducing a maximum size for bids
- Transparency through publication of auction calendar, volumes and results
- Reporting of auction data to financial authority

Oversight in practice

Secondary market

- The market is supervised by the financial authorities of 27 EU Member States, under the coordination of the European regulator, the European Securities and Markets Authority (ESMA)
- Robust reporting and transparency requirements for trading venues and investment firms
- Market participants obliged to report suspicious orders and transactions without delay
- National authorities have the power to impose remedial action or sanctions

Oversight in practice



Stocktake of the last 16 years

- Gaps in carbon market oversight have been addressed over time:
  - VAT carousel fraud cases (2009-2011) → VAT reverse charge mechanism
  - Theft/cyber attacks → security measures in the Union Registry similar to bank accounts
  - Recycling of international credits → international credits are no longer eligible for use in the EU ETS

- **Since 2018, all trading in emission allowances is effectively subject to the same regime applicable to EU financial markets**

Useful links:

- **Carbon Market Report**
https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0740

- **DG Clima website** >> EU Action >> ETS >> Market oversight
https://ec.europa.eu/clima/policies/ets/oversight_en

- **ETS Directive**
https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02003L0087-20200101

- **Auctioning Regulation**
https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1525080408788&uri=CELEX:02010R1031-20171108

- **Registry Regulation**
https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02019R1122-20210101