

Testimony of Jon A. Anda

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Thank you for the opportunity to testify before this Committee today. My name is Jon Anda and I am a Visiting Fellow of the Nicholas Institute for Environmental Policy Solutions at Duke University. I was previously President of the Environmental Markets Network at the Environmental Defense Fund. Prior to that time, from 1986 through 2006, I was with Morgan Stanley where I served in a variety of roles including Vice Chairman, Global Head of Capital Markets, Head of Corporate Finance, and Head of both the Institutional Equity and Investment Banking Divisions for the Asia Region.

During the past 2 and ½ years, at both Duke and Environmental Defense, I have worked to create a framework for the U.S. carbon market that is fair, efficient, and responsive to lessons learned in the financial crisis. The Bill's carbon market section sets the right tone to accomplish these same objectives - with key decisions like best execution and listed derivatives trading - being made correctly by the Committee.

Let me begin with a few points about the potentially small initial "float" of allowances – which is essential to framing this discussion:

1. The Bill provides for 131 billion allowances over the life of the policy, although as few as 5 billion may be outstanding initially. Thus, the so-called "float" of allowances in circulation is small relative to the total. Put another way, we are asking emitters to take on 38 years of abatement with as little as 1 year of allowances available to manage their risk. This will drive huge demand for derivatives – making them the "tail wagging the dog" in the U.S. carbon market. This highlights the correctness of the Bill's provision to keep derivatives trading on so-called designated contract markets (or DCM's) – which are essentially regulated and transparent exchanges. Obviously, offsets should pick up quite a bit of the slack on float - but not enough to fundamentally alter these initial market dynamics.
2. Let me mention one potentially important technical issue – linkage of listed derivatives to the physical supply of allowances. You all remember, I'm sure, that the notional value of credit default swaps got to over \$70 trillion - far larger than the value of the underlying credit instruments. The Government may need to explicitly guarantee that enough unsold future allowances will ultimately get distributed in time for the expiration of listed derivative contracts.
3. Now let me point out a few ways to make the initial float bigger. The first is to use the Bill's provision to auction as many as 4 future vintage-years' worth of allowances upfront. But this will tend to create auction sizes too large to be executed efficiently - remember that at about \$20 per ton, we would already have a \$100 billion first year auction if we do 100%. The second alternative would be to front-end load any free allocations to ensure a liquid carbon market that is less

derivatives-dependant. This rationale alone, beyond leakage and other issues raised to the Committee, might be a reason to consider some degree of free allocation. The third alternative is to boost the float synthetically – which could be done by adding Allowance Purchase Rights (or APR's) to the regular allowance auctions. APR's could, for example, allow the holder to purchase allowances in 4 years time at \$15 per ton. The APR's could be a useful listed hedging tool - as well as effectively providing emitter financing (since the \$15 isn't paid for 4 years). APR's don't have to change the cap – they can just be a means of pre-selling Government-held allowances.

Now, with that context, I'll go back to best execution, listed trading of derivatives on DCM's, and early opposition to the Bill's market provisions:

1. First - best execution means that when you buy or sell an allowance you are assured of getting the best price available across all potential trading venues. This is critically important for two reasons – first, because carbon prices flow quickly through to consumer's prices – and, second, because not all emitters have the capability to arbitrage across non-linked markets. The question is this: at what point is the Bill's National Market System linking competing exchanges too cumbersome relative to a single marketplace? The Commission might consider the alternative of having the Regulator outsource operation of a central limit order book for carbon allowances - what I call a "CLOB for carbon" (though the Bill as written is fine as well). A "CLOB for carbon" is something I'll leave for Q&A.
2. Second – listed derivatives trading is arguably the most critical provision in the carbon markets section. I want to suggest a quid pro quo, though, for mandating derivative trading on exchanges – which is rational accounting treatment for the emitters and project developers who use them. Let me explain this a bit further. Sometimes corporations use structured OTC instruments to avoid mark-to-market accounting of listed futures or options. They do this is because mark-to-market makes their earnings less predictable. It seems that emitters should be able to hold futures and options with physical delivery (as well as banked or borrowed allowances) and treat them as a deferred expense *provided their intention is to submit the underlying allowance for compliance*. Rational accounting (which is even highlighted in the USCAP blueprint) goes hand-in-hand with the Committee's DCM mandate.
3. Third, I think opposition to the Committee's carbon markets provisions merit a few comments. First, we all recognize that unrestricted markets are theoretically the most efficient – yet if we expose a new market to systemic risk then the risk might overwhelm the efficiency benefit. We certainly saw this in markets like sub-prime mortgages and credit default swaps. In the case of climate policy, systemic risk in the carbon market might necessitate easing emissions targets – and what happens then? Well, we go back to systemic risk in the atmosphere - negating the Bill's

raison d'être . Secondly, the point has been raised that long-term derivative trades (say 7 to 10 years) are best negotiated between 2 parties – but there is no reason such trades can't be arranged off-exchange by two parties, and then “printed and cleared” on an exchange (as happens in the normal course on most exchanges). Third, while the Bill as written may constrain certain highly customized bi-lateral arrangements, the Commission can consider the degree to which such arrangements, if at least partially cleared on a registered exchange, can have an acceptable degree of residual bi-lateral risk and still be transacted. Lastly, opponents complain about the Bill restricting OTC trading of “pre-approval” offset credits – yet the Bill doesn't specifically restrict these – and final regulations may, in fact, confirm that OTC trading is appropriate for these types of transactions.

In conclusion, we recognize the concerns of many about carbon market structure – if it is done wrong it would bring a host of difficulties. But it could also be done well – with carbon being a transparent and well-overseen market that sets an example for other markets.

I realize my 5 minutes have been a bit technical – but more basic information can be found in the Nicholas Institute's primer on carbon markets (which is an appendix to my testimony). Thank you for allowing me, with the support of my colleagues from the Nicholas Institute, to provide input to this Committee.

I look forward to answering any questions you might have.