European Federation of Energy Traders

Barriers to Emissions Trading under the EU-ETS

EFET Emissions Trading Task Force

Executive Summary

EFET Emissions Trading Task Force has polled its members on their views as to the Barriers to Trading under the EU-ETS.

Responses were received from ten companies, based in six member states. Results were circulated to over thirty-five companies, based in twelve member states.

Barriers Fall into four main areas;

- Uncertainty of supply/demand
- Inappropriate regulatory arrangements
- Fragmentation
- Other Issues

This paper gives details of the individual barriers identified.

Attached, as an appendix, are a set of slides summarising this paper.

Introduction

The EFET Emissions Trading Task Force (ETTF) has the objective of promoting EFET's objectives in the field of emissions trading. Currently it is strongly focused on the EU-ETS. It has a membership of over 30 companies across 12 member states.

To progress the agenda of the EFET ETTF it decided to poll it's members on what they see as the Barriers to Trading under the EU-ETS. Ten companies provided responses to this poll in varying degrees of detail. The results of the poll were summarised and circulated to the full membership. Comments were then taken and the results of the poll refined.

This paper summarises the results of the process set out above and provides, in the view of the EFET ETTF, a strong indication as to the views of European Energy Traders.

Detail of Individual Barriers

Uncertainty of supply/demand

In all markets there is uncertainty over the supply/ demand balance and this does not always stop the development of a liquid traded market. Experience in other markets does however suggest that uncertainty from the rules or trading arrangements is particularly damaging to liquidity and the development of a forward curve. For the EU-ETS this sort of uncertainty appears to come from two areas; uncertainty designed into the scheme and uncertainty caused by the lack of clarity in the scheme. Of particular concern is uncertainty over the NAPs.

Uncertainty of supply/demand – designed in uncertainty

- Soft cap on JI/CDM - The current linking directive only includes a soft cap of 6% on JI/CDM credits recognition under the EU-ETS. No firm cap leads to increased uncertainty over the level of supply of EU-ETS allowances. The linking directive should be modified to either remove the cap or make it firm.
- Free allocation to new entry – The scheme allows MS to set aside allowances for new entrants. The amount of new entry is uncertain and hence the allocation is uncertain.
- Use of 'opt-out' – The scheme allows installations to be opted out on passing an equivalence test. The extent to which opt-out is used is uncertain and this introduces both supply and demand uncertainty.
- Banking of allowances from 2007 to 2008 – The scheme allows banking between periods. This leads to uncertainty in both periods affecting the development of a forward curve.
- Difference in allocations methods between member states – The scheme allows wide scope for variations in allocation methodologies. This makes it complex to build a view of supply. Strong guidelines for member states on allocation methods would reduce this barrier.

- Different NAP methodologies in 2005-07 and 2008-12 - The scheme allows MS to change their NAP methodologies between periods. Once again this makes it complex to build a view of supply.
- No standard for allocation on closure – The scheme allows MS to decide how to allocate to closed installations. This makes it complex to build a view on supply and demand. A standard position across the EU would avoid this barrier.
  Uncertainty of supply/demand – Lack of clarity
- Uncertainty about the use of CERs/ ERUs due to Kyoto Protocol non-ratification – With no certainty over ratification this leads to issues around supply forecasting. It would be useful if there was clarification of the position should ratification not occur.
- Legal certainty across MS – The legal status of allowance across MS may differ. Clarity of the position would improve liquidity.
- No detailed product description of EUA – Linked to the legal position, it would be very useful to have clarity as to the status of EUAs across the EU and MS.

Inappropriate Regulatory Arrangements

Regulation of markets is commonplace and energy traders deal with this across the EU. The level and extent of regulation are major drivers in the cost of participation in a traded market. Inappropriate regulation will mean that entry into the market will be constrained in an inappropriate manner. A further risk is that inappropriate regulation will lead to a fragmentation of the market.

- Price disclosure/transaction disclosure – Some MS are considering placing obligations on participants to report transactions and price. Such obligations should be minimised.
- Complex regulatory procedures - Currently some decisions are made on the scheme, without adequate consideration of participant's views. This can lead to overly complex trading arrangements. The views of participants should be particularly useful in developing trading arrangements and avoiding unnecessary complexity.
- Onerous financial services regulation of allowance transactions – There is a risk that the financial services regulations around allowance trading will be inappropriately onerous. Some pan-EU standardisation may avoid inappropriate regulation.
- Paperwork/control/legal requirements concerning the emission authority – similar to the barrier above, again standardisation with focus on best practice should help avoid inappropriate regulation.

Fragmentation

The aim of the scheme is to deliver a pan-EU traded market with allowances being fungible across MS. Different rules in different MS will mean transaction costs will vary and there is also risk that a lack of standard documentation (e.g. master agreements) could lead to market fragmentation.

- Legal status of allowances – covered above.
- Tax treatment of allowances – There may be differences in the tax treatment of allowance across MS; although not inevitable there is a risk that this could lead to fragmentation. There are also operational issues such as invoicing. Some standardisation, perhaps lead by EU wide guidelines could reduce this risk.
- Registry issues – There is a risk that if registries are not implemented correctly this could lead to fragmentation. To reduce this risk it is suggested that;
    1. There are harmonised transfer procedures/rules/timescales,
    2. The responsibility for registry and registry maintenance is clear,
    3. The delivery of registries is a priority.
- Standardised contracts/Master Agreements – Experience of other traded markets suggest that a lack of standard documentation can cause barriers to trading. EFET is active in promoting standard documentation.
- Different timescales in each MS – There is a risk, particularly early in the development of the market that different timescales will lead to fragmentation. Deadlines should be published and enforced to prevent differences.

Other Issues

There are some issues which could lead to barriers and do not fit neatly into the categories above.

- Credit issues – For many companies the counterparties trading allowance may be different to counterparties trading other commodities. This may lead to concerns around credit and counterparty approval.
- Non-continuous market – The structure of the scheme into periods may lead to a concentration of trading close to end periods. This may be a barrier to trading at other times.

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Appendix – Summary Slides

Barriers to Emissions Trading under the EU-ETS

EFET

Summary

- Collection of views from EFET New Energy Task Force
- Responses from companies based across Europe
- Barriers fall into four main areas
  - Uncertainty of supply/demand
  - Inappropriate regulatory arrangements
  - Fragmentation
  - Other Issues

Uncertainty over supply/demand

Any market has uncertainty over supply/demand BUT...

- Uncertainty from 'rules' is particularly damaging to liquidity and development of forward curve
- Uncertainty comes from two areas
  - Designed in uncertainty
  - Lack of clarity

Uncertainty over supply/demand Detailed Issues

- Designed in;
  - Soft cap on JI/CDM
  - Free allocation to new entrants
  - Use of "opt out"
  - Banking of allowances 2007 to 2008
  - Difference in allocation systems between MS
  - Different NAP methods for 05-07 and 08-12
  - No standard for allocation upon closure of an installation

- Lack of clarity
  - Uncertainty about the use of CERs/ERUs dues to Kyoto Protocol non-ratification
  - Legal certainty across MS
  - No detailed product description of EUA

Inappropriate Regulatory Arrangements

- Regulations affect the cost of trading
- Inappropriate or over regulation will limit trading of emitting parties and reduce entry of third parties
- Inappropriate regulation in some MS may lead to fragmentation

Onerous regulations Detailed Issues

- Price disclosure/transaction disclosure
- Complex regulatory procedures
- Onerous financial services regulation of allowance transactions
- Paperwork/control/legal requirements concerning the emission authority

Fragmentation

- Different rules in different MS will mean transaction costs will vary
- Risk that allowances may not by fully fungible
- Also risk that a lack of standard documentation (e.g. master agreements) could lead to market fragmentation

Fragmentation
Detailed Issues

- Legal status of allowances
- Tax treatment of allowances
- Registry issues
  - Harmonised transfer procedures at Registries
  - Responsibility for Registries
  - Delivery of Registries
- Standardised contracts/Master Agreements
- Different timescales in each MS

Other issues

- Credit issues
- Non continuous market leading to concentration of trading close to end periods