



## **Barriers to Emissions Trading under the EU-ETS**

### **EFET Emissions Trading Task Force**

**Brussels, June 2003 UPDATE**

#### ***Executive Summary***

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

For the first version (December 2003) responses were received from ten companies, based in six member states. Results were circulated to over thirty five companies, based in twelve member states. This update (May 2004) is based on the response from eleven companies and was discussed on April 28 with ten EFET members of the task force. The current document will be circulated under the fifty-three task force members and is planned to be discussed with the EU in June 2004.

Barriers Fall into four main areas;

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

This paper gives details of the individual barriers identified and is supplementary to the presentation.

## ***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 its 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. The first version was published in December 2003 and this version (May 2004) is an update based on the publications of the National Allocation Plans and the "new" Linking Directive.

## ***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

- Use of JI/CDM in phase 1 and 2 - In the latest draft of the Linking Directive, no cap is set, but (i) the uncertainty on the use of JI/CDM in the 1<sup>st</sup> phase and (ii) the application of a cap per installation in the 2<sup>nd</sup> phase is now lying within each MS' decision. There is large room for interference for the MS which introduces uncertainty. As long as the use of JI/CDM remains uncertain, establishment of forward curves and liquidity will be hindered.
- Use of reserves - The scheme allows MS to set aside allowances for new entrants, legal actions, etc. It should be clear in the NAPs how these reserves will be used (e.g. what happens if there is still a reserve at the end of 2007) to reduce the uncertainty surrounding the volume of allowances that can enter the market.
- Banking of allowances from 2007 to 2008 – The scheme allows banking between phases. This leads to uncertainty in both phases affecting the development of a forward curve. To date, no Member State has opted to make use of this provision and this common

approach is welcomed as a way of containing any initial errors to phase I of the scheme. However, if banking would happen in a country it could lead to a fragmented market with different prices based on the origin of the allowances.

- Clear, certain and fixed NAPs - With NAPs now being submitted to the Commission, the onus must now be on the Commission to ensure that the process in place to scrutinise each NAP is both thorough and robust. The NAPs should be clear on the total amount of allowances that will be used under the EU ETS and this number should be certain and fixed for the first phase.
- Different NAP methodologies in 2005-07 and 2008-12 - The scheme allows MS to change their NAP methodologies between phases. To enable market participants to build a view of supply, key phase II principles must be made available as soon as possible, i.e. how will new entrants and plant closures be treated in phase II.
- No standard for allocation on closure, new entrants, use of reserve – The scheme allows MS to decide to set-up their own definitions regarding these issues. This makes it complex to build a view on supply and demand. The use of standard definitions across the EU ETS would avoid this barrier.

#### Uncertainty of supply/demand – Lack of clarity

- Legal certainty across MS – The legal status of allowance across MS may differ. Clarity of the position would improve liquidity otherwise it could lead to a fragmented market.
- 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. A standardization of the product would improve the market liquidity.

#### **Inappropriate Regulatory Arrangements**

Regulation of markets is common place 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 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 is still a lack of clarity surrounding tax treatment, in particular regarding VAT. 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.
- 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.

## **Realisation of the registries**

- 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.

## **Other Issues**

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

- Non continuous market – The structure of the scheme into phases may lead to a concentration of trading close to the end of phases. This may be a barrier to trading at other times.

## **Draft Update June 15, 2004**