

# EFET Position on the EU ETS Review

## EFET Task Force on Emissions Trading

### 1 Introduction

EFET is the European Federation of Energy traders, and represents 75 companies from 18 European countries. These companies and organizations are actively trading in the European emissions trading market. EFET gladly takes the opportunity to provide constructive input for the review of the EU Emissions Trading Directive, 2003/87/EC, built on the experience of its members in the emissions trading so far. EFET members have had experience in EU emissions trading already since 2003, experience in other emissions trading schemes, e.g. in Denmark or the UK dates back even to 2001. The EFET Task Force on Emissions Trading has the objective of promoting the objectives of EFET in the field of emissions trading. Currently it is strongly focused on the EU ETS.

The EU ETS went, in terms of trading, off to a promising start, with high volumes of allowances traded and a real cost of CO<sub>2</sub> emissions resulting from transactions. To retain this momentum, the EU ETS has to be improved further. Also EFET finds it important that no changes are implemented that will hinder the functioning of the market.

By applying the general principles laid out in this paper, and addressing the specific issues raised, the EU ETS can evolve towards a robust and mature market that provides a vital framework for globally coordinated action against climate change. EFET willingly offers its expertise and assistance in achieving this goal.

### 2 General principles

EFET is especially concerned with the proper functioning of the emissions trading system and market. A number of key principles have to be met to ensure this:

- Liquidity in terms of traded volume and active traders
- Level playing field for participants
- Clarity on regulatory aspects
- Clarity on factors that drive supply and demand
- Proper functioning supporting systems

In order to achieve an optimal functioning of the emissions market, the “rules of the game” have to be set in such a way that these key principles are met. Timeliness of regulation, clarity on key determinants of the market and harmonization where appropriate are key success factors to the functioning of the EU ETS. In addition, proper defined processes and supporting systems are needed.

## **2.1 Timeliness**

Timeliness of processes relates to the national registries, as well as to the allocation process. All registries for emission allowances and the CITL should be fully operational before September 2005, since the majority of forward transactions of 2005 allowances will be settled in the last months of 2005. The CITL and national registries should enable transfers of EUAs, AAUs, CERs and ERUs.

Furthermore, the national registries make spot trading of allowances possible. Spot trading will help to mature the market and deliver the necessary liquidity. The number of participants active in the market will grow when spot trading becomes widely accessible, because it entails less financial and delivery risks. The limited access to spot trading prevents in particular smaller companies and companies from the new Member States to actively participate in the EU ETS.

The NAP process for the second trading period should be finalised no later than mid 2006, as laid down in the Directive 2003/87/EC, for market participants to be able to analyze the consequences of the national allocations on the allowance market. This is crucial to ensure that companies can analyse the feasibility of investments in emission-reducing projects. Uncertainty regarding key determinants of the allocation in the second trading period leads to postponement or cancellation of these investments.

## **2.2 Clarity**

Clarity should be provided on a number of key issues determining the structure of the emissions market. The National Allocation Plans should contain a clear, certain, ex ante and fixed (excluding ex post adjustments) number of emissions allowances per installation. Otherwise the market participants can not estimate the price development, which complicates operations in the markets and investments decisions.

Inclusion of other gases and/or sectors are issues that greatly influence the structure of the market, therefore clarity on whether there will be such an expansion, and the design of this expansion, is of vital importance to the market participants.

Member States that choose auctioning as a method of allocation for the 2008-2012 period, should provide sufficient clarity in their NAP on the method of auctioning, when the auctioning will take place, how much of the national allocation will be auctioned, and which parties will be eligible to participate in the auction. Auctions of emission allowances should be open to every person or organisation holding an account in a national registry of an EU Member State.

## **2.3 Harmonisation**

Harmonisation among Member States should be strived for in the second period, where appropriate. Differences in allocation methods across countries can result in optimization difficulties for companies with a cross border emissions portfolio. EFET welcomes any initiative from Member States and the European Commission to discuss the possibilities for a more harmonized allocation for the 2008-2012 period.

Because differences in the allocation method will probably persist in the second trading period, the NAPs should provide sufficient transparency on the allocation method and rules. A standardized format for NAPs with minimum requirements for the content of the document would be a good first step towards more harmonization and transparency. EFET offers willingly to provide assistance in the draft of a template for a more transparent NAP.

Other key determinants of the scheme, such as rules governing closures of installations that fall under EU ETS, transfers of allowances and allocation for new entrants, should be the subject of further harmonization and guidance by the European Commission.

The current definition of installations covered by the scheme differs among Member States and should be harmonized. The differing interpretation among Member States brings about less transparency and negative incentives in the market. A harmonized interpretation of which installations are covered by the Emissions Trading Directive is therefore necessary.

### **3 Specific issues**

#### **3.1 Allocation method**

In order to preserve the proper functioning of the market, the National Allocation Plans of all Member States should be published before July 1st of 2006, as stated in Directive 2003/87/EC, Article 9, Paragraph 1. The European Commission should facilitate the timely draft of the NAPs by improved guidance documentation and a standard format for the NAPs. The lessons learnt in the allocation process for the 2005-2007 period should be incorporated in a revised version of the guidance on NAPs from the European Commission, COM(2003) 830 final.

The allocation to installations should be fixed and not be adjusted ex post. Ex post adjustments hinder the functioning of the market by making it less transparent and by introducing inequality.

#### **3.2 Inclusion of other gases and sectors**

In principal, expansion of the scheme with other gases and/or other sectors will increase liquidity and thus support the market. EFET therefore favours expansion of the scheme, as long as a number of conditions are met. The benefits of inclusion of other sectors have to outweigh the possible disadvantages, which might include less transparency, unreliability, high administrative costs or a sharp change of allowance market prices.

**Other gases:** Only gases that can be monitored in a technically feasible and credible way may be included. The effect of these greenhouse gas emissions on Global Warming should be sufficiently known. Emissions of these gases should be based on this Global Warming Potential and expressed in CO<sub>2</sub>-equivalents.

**Other sectors** (e.g. aviation, road transport, chemical installations): Inclusion of other sectors should only take place after careful consideration of the benefits and the costs, on a case by case basis (sector by sector). Possible benefits of expansion with other sectors include lower abatement costs for the sectors to be included and larger liquidity in the market.

Drawbacks could occur where abatement costs for included sectors are prohibitive, which could lead to severe price hikes in the market and distort the market. Secondly, sectors to be included and their representative companies should emit substantial amount of greenhouse gases. If a sector only includes small emitters, the environmental benefit remains low and the addition does not increase cost-efficiency.

In sectors where the allocation of allowances is ambiguous, such as aviation and road transport, it should be established first where emissions are to be counted, and consideration has to be given to possible perverse incentives of the inclusion of these sectors. Finally, only sectors in which emissions, and their global warming potential, can be monitored and verified accurately and at reasonable cost should be included.

Decisions on the inclusions of more gases or sectors have to be made during the allocation process for the 2008-2012 period, and should be communicated to the market participants as soon as possible, giving them enough time to prepare for the expansion of the scheme.

### **3.3 JI/CDM cap and eligibility criteria**

A limit on the use of JI/CDM should not be adopted because the use of project based credits generates higher cost efficiency of the system. The expected supply of CDM and JI credits until 2012 is lower than expected demand, therefore emissions reductions within the EU will always have to bridge a substantial part of the expected shortage of allowances.

No additional criteria for acceptance of projects should be introduced, since Host Countries, the Executive Board (CDM), the Supervisory Committee (JI) and the Linking Directive will provide sufficient scrutiny for the admittance of CDM and JI projects. Additional criteria for project eligibility that are created in the transposition of the Linking Directive in national legislation will create unnecessary regulatory hurdles for the development of CDM and JI projects and will further increase the complexity of the system.

To make the actual use of CERs and ERUs in EU ETS possible, the ITL and CDM registry should be up and running at the latest in the summer of 2006. The funding of these systems should be raised shortly by the Parties to the Kyoto Protocol.

### **3.4 New entrants/transfers/closures/surplus reserves**

Rules on new entrants, transfers and closures should be clear and unambiguous, to enable market analysis. Rules should be set in a way that makes it feasible to execute and maintain them. There should be clarity in the NAPs about what happens to new entrant reserves that are not depleted, as unexpected cancellation or dumping of these reserves will distort the market.

### **3.5 Legal issues**

There could be problems for companies with an international CO<sub>2</sub> portfolio and companies which are trading cross-border, if the legal status of allowances is not clear. Questions on the character of the ownership of the allowances (Does a buyer of allowances have full ownership or beneficial ownership? Is security lending on allowances permitted?) have to be solved shortly to prevent obstruction of transactions. These questions on the legal status of the allowances also lead to uncertainties regarding liability, accounting and regulatory issues.

EFET applauds the decision of the VAT committee to endorse the harmonized interpretation of the VAT treatment on emissions trading (VAT levy in place of supply), and encourages the VAT Committee to maintain a harmonised VAT treatment throughout Member States.

Pre-emption rights for tax agencies regarding the allowance property of a participant in emissions trading will increase the uncertainty in forward transactions and should therefore not be introduced in insolvency regulations by Member States.

### **3.6 Registry management**

Sharing information and best practices among the Registry managers of the Member States will improve the quality of the registries. A structured consultation process among Registry Managers and market participants would be advisable. EFET therefore welcomes the initiative of a number of Member States to seek more cooperation in further development of the registries.

The early experiences with the German registry once more bring about the need to solve the liability issues resulting from failure of the registry.

Electronic interfaces can improve the communication with the registries, especially for participants with multiple accounts and for trading platforms. In the near future, very large numbers of transactions will have to be communicated to the registry at the same time (e.g. the delivery date of most 2005 forward transactions is 1<sup>st</sup> of December 2005). This will only be feasible, when trading companies can send their input data electronically to the registry. Manual input of these data could lead quite likely to a delivery delay and could also be a huge source of transaction errors. EFET recommends the use of already existing systems for international gas and electricity trading and offers its assistance in the realization of this interface.

### **3.7 Accounting issues**

The cap and trade approach of the EU ETS creates intangible assets (allowances) and liabilities (obligation to cover emissions with allowances) that must be captured in financial statements and could represent a significant figure for companies. Financial reporting guidelines for these new assets and liabilities haven't been drafted by the International Financial Reporting Interpretations Committee (IFRIC) in December 2003. The valuation of these assets and liabilities can lead to mismatches, as the assets (allowances) are valued at cost in accordance with IAS 38, and the related liability is measured at market value (IAS 37). The impact of emissions trading on the profit & loss account and balance sheet is thus being determined by reporting regulations and does not necessarily reflect the performance of the business.

Furthermore, the accounting treatment of government grants (IAS 20) is currently under review by the International Accounting Standards Board (IASB).

These uncertainties regarding the valuation and reporting of emissions and allowances create severe accounting problems for companies that fall under the emissions trading directive and therefore should be resolved as soon as possible. EFET therefore advocates an amendment to the IAS 38, and welcomes the fact that IFRIC is currently discussing this topic.

### **3.8 Financial services regulation**

More strict regulatory requirements for participating emissions traders (e.g. capital reserve requirements for participants) can become a severe barrier to market entrance. Emissions trading has been imposed on the participants by EU legislation and should not be hindered by other EU Directives. Therefore the MiFID Directive that is currently being drafted should take easy access to the EU ETS into account and not produce additional financial or regulatory burdens for participants in the EU ETS. Member States should deliver some level of harmonization to enable smoother market operations. In the current situation, licenses are obligatory in some countries, whereas in other countries they cannot be applied for. These differences between Member States regarding financial services regulation result in a fragmented market and should be addressed by the Member States as well as the European Commission. This process should lead to a clear distinction between transactions in emissions trading that are governed by financial services regulation, and transactions that are not.

### **3.9 Commitment Period Reserve**

The rules regarding the Commitment Period Reserve could cause situations in which a national registry is blocked because a Member State's allowances reserve is less than 90% of its emissions. This event would lead to severe distortion of the market. Solutions should be sought to surpass this problem, a possible solution is having the CPR rule only apply to the EU Kyoto target and not to the targets of individual Member States.

### **3.10 Linking to other schemes**

Linking to other emissions trading schemes will be favourable for the EU ETS, by improving liquidity and cost effectiveness. Linking to Norway seems possible in the short term. Before the Norwegian scheme is linked to the EU ETS, market participants need to be fully informed on which installations and the number of allowances this linkage concerns.

Clarity should be provided shortly on the framework of the CO<sub>2</sub> market after 2012. Enlargement of the EU ETS, or linking to other schemes/annex I countries (Switzerland, Canada, Japan, New Zealand) should be the cornerstone of a post 2012 strategy. Full fungibility of EUAs with GHG-units from these other schemes should be guaranteed. Linking to non-Kyoto Parties should also be considered (e.g. to schemes on American state level), but only on the basis of full reciprocity with the EU ETS.