

EFET letter, October 2002

Appropriate Heads of Unit, DG Environment and DG TREN,
European Commission
and/ or
Members of the European Parliament
and/or
Appropriate officials in Member State ministries

Dear

Establishing a viable European Union framework for CO2 emission credits trading

EFET's objective in sending you this letter is to stress the absolutely essential elements of any future, viable, EU-wide emission credits trading scheme.. We do this in the full knowledge of the difficulty of achieving a consensus among Member States and in the European Parliament on the appropriate mechanisms.

We have followed the debate about the Commission's proposal for a directive, establishing a framework for greenhouse gas emissions trading within the European Community, especially in relation to the design of the market and the instruments. We believe that in order for the EU to maximise the chances of Member States achieving their CO2 reduction allocations cost-effectively, they must set sectoral targets involving real obligations for individual enterprises. Only real obligations, duly enforced where necessary, can underpin the confidence needed for a liquid and transparent market in emission credits to evolve. To put the analysis a different way, whatever the original source of emission permits or exemptions for a particular enterprise in a particular sector (from "grandfathering", through benchmarking, to auctioning), those permits or exemptions must later have the potential to become truly market-based instruments. And any successful market-based instrument is founded first and foremost on legal certainty.

The European Federation of Energy Traders (known as EFET) is an association constituted under Dutch law with 53 full and 15 associate members in 14 European countries. The main objective of EFET is to promote the development throughout Europe of wholesale markets in electricity, gas, other energy commodities and linked instruments and contracts. In so doing we foster standardisation of documentation used by, and interfaces between, traders. We also identify the obstacles to trade in energy commodities between European countries and strive for the abolition of such obstacles. EFET members, being the larger or medium sized energy trading companies, including the trading arms of the largest utilities, are already responsible for more than 80% of all electricity traded in Europe. EFET members have also been

working for several years on renewable energy projects and, more recently, on renewable certificates trading. For more background on EFET see our website: www.efet.org.

We now examine the essential elements of any viable emission credits trading scheme, under the following headings:

- (1) Liquidity, transparency and harmonisation
- (2) Certainty of obligations and regulation

(1) Liquidity, transparency and harmonisation

A. Electricity trading: A relevant lesson in optimising wholesale markets

In the old European world of integrated power utilities, each enjoying an exclusive position in a particular geographical area, there was no concept of an open energy market. These monopolies or oligopolies were entitled to restrict use of their grids for the benefit of their own production and supply activities. Plant dispatch was merely a function of establishing an internal merit order for their captive needs. Transactions with other generators and suppliers normally took place just for the purposes of system security, seasonal swaps or occasional cross border supply contracts. For these reasons there was no real competition in power generation and supply nor any general price discovery across the (then) UCPTE area.

Now an increasing number of consumers enjoys freedom to choose their supplier. With the advent of choice comes the necessity of establishing an efficient marketplace in power as a commodity. Generation and supply have become separated functions in commercial terms. Intermediation in power sales and purchases by a variety of electricity undertakings tends to bring supply into equilibrium with demand at real market prices. This in turn underpins liquidity and transparency. Thus, the emergence of this wholesale market and the activity of the parties intermediating lead to portfolio optimization and sophisticated risk management. It is in this sense that traders contribute crucially to increasing efficiency and competitiveness in the sector overall.

B. A “wholesale market” in emission credits

EFET presumes that the potential benefits of trading of emission credits are understood and accepted by informed EU policymakers and commentators. The essential point is that *economically efficient* transfer of the relevant permit or exemption leads to a cost-effective reduction of greenhouse gases, because a contributory technical abatement measure may then be taken by the company that can achieve the greatest mitigation effect at least additional cost.

However, transfers are unlikely to be achieved in an economically efficient manner, unless a “wholesale” marketplace in the appropriate instruments is accessible to those who may wish to commit to additional abatement measures, as well as those who may wish to avoid them. And even accessibility is not alone sufficient; all potential participants must have confidence in the reliability of the price signals given in that marketplace. Here is where liquidity and transparency come into play for emission credits trading, just as they do in the example of the power commodity markets given at 1) A. above.

What conditions may we suppose will facilitate the development of liquidity and transparency in a new world of flexible mechanisms to help deal with greenhouse gases? Low transaction costs and a large number of participants are certainly prerequisites. For this reason we advocate that the coverage of an EU scheme should be widened and harmonized to include all relevant industrial sectors with emissions, right from the start. In the interests of further extending coverage, the scheme should ideally also include all greenhouse gases mentioned in the Kyoto Protocol, rather than restricting it to just CO₂. However, EFET recognises that extending coverage to all six GHGs would have major cost implications and is likely to be inefficient for the majority of participants.

C. Achieving liquidity and transparency on the basis of a clear, consistent legal framework

Beyond the questions of scope of the scheme and transaction costs, we believe that the secret of realising the necessary degree of liquidity and transparency lies in creating an enforceable series of obligations on emitting parties at the national level, which fit together and are actually enforced on a pan-European scale. That in turn decrees resolute and swift action at the EU level. We examine the three most important dimensions of such action in our following section 2.

D. Harmonisation of national systems

In order to increase the number of participants in a future European market for emission credits, it would seem inevitable that national systems should be harmonised EU-wide and across the accession nations too. Otherwise the cost-effectiveness of emissions trading can only affect smaller subsets of countries but not Europe as a whole. However we are concerned that the current divergence between countries, in their approach to achieving both national reduction quotas and sectoral targets, may only be exacerbated in the future, if rapid action is not taken now. This divergence is of particular concern in relation to those countries which apparently have no plans to enforce obligations ultimately against individual emitting entities, as opposed to seeking undertakings from industry associations or similar bodies.

In the course of achieving harmonisation, it is also important to ensure that allocation methodologies are transparent, take into account the EU burden sharing agreement and do not result in significant market distortion between sectors and/or Member States. It is particularly important that all Member State allocation processes are fixed in advance to provide market certainty (see 2) below).

(2) Certainty of obligations and regulation

Legal certainty with regard to the obligation, which underlies a CO₂ emission permit, exemption or credit, will be essential, to create a reliable framework for the evolution of traded contracts, which transfer the obligation. Even more fundamentally, if Member States are allowed to opt for measures, which do not create any enforceable obligations in the first place on particular enterprises in sectors responsible for significant emissions, then no comprehensive framework could evolve. And if a series of frameworks, varying by industry and/or geography and/or degree of enforceability, transpires, then tradability of the ensuing instruments will be imperilled by complexity, opacity and uncertainty. Apart from basing the scheme on the mandatory creation of legally enforceable obligations to comply with allocated permits, what other features of it will require additional certainty?

EFET suggests six areas for attention. We raise these at this stage for discussion, without necessarily stipulating solutions or improvements:

- A. Transparent, possibly market based, initial allocation of allowances to individual emitting parties.
- B. Clarification of the role of financial regulators with regard to the trading of emission credits (see separate EFET letters to DG TREN and DG Internal Market concerning application of ISD to energy commodity derivatives)
- C. Resolution of VAT treatment on traded deals between countries.

D. No further intervening instruments

The Commission's proposal for a directive does not rule out the use of further political instruments to achieve national reduction allocations nor to fulfil sectoral targets. The cost-efficiency of emissions trading will be strongly enhanced, if no other climate change measures are implemented with a direct equivalent effect on the parties likely to sell or buy emission credits. This would mean e.g. that companies eligible for emissions trading schemes should not be subject to environmental taxes designed to contribute to national greenhouse gas reduction. Otherwise offsets are to be expected. We strongly support the adoption of market-based mechanisms such as emission credits trading, in preference to taxation, as an economically efficient means to achieve national allocations and, especially, sectoral targets.

E. Finite lifetime of certificates as alternative to banking periods

The Commission's proposal considers the use of two banking periods: 2005 – 2007 and 2008 – 2012. The use of banking periods can lead to extreme price behaviour at the end of each term. If there is a general shortage (or excess) of credits at the end of the banking period, the price of traded credits on the market will increase (decrease) sharply. To avoid this unnatural price behaviour, it would be better to have no banking periods, but a finite lifetime for the original allowances as allocated without charge or purchased or auctioned, e.g. each year allowances could be allocated with a lifetime of e.g. 5 years. This solution would allow a banking mechanism but avoid the shortage (excess) problem at the end of a banking period.

F. Non-compliance penalties

The Commission has proposed a penalty for companies which fail to fulfil their obligations. In principle we agree to this method because it should constitute an efficient incentive for companies to avoid GHG emissions. However the proposed penalty, as a maximum of 100 € (50 €) or twice the market price, could lead to some problems, since market prices will be difficult to determine. In OTC trades for example usually neither of the two counter-parties will wish to reveal their agreed price. In an illiquid market there may even be situations, which do not properly reflect at all the value of the emission allowances at a given time, because there are only buyers or sellers on the market. Therefore we prefer the adoption of a fixed penalty approach.

EFET stands ready to answer any of your questions about our above stated viewpoint, and looks forward to hearing your reaction.

Yours etc.

CC: Jorge Moreira da Silva MEP