

Failings of the European CO₂ emissions trading market

Summary of the discussion

In view of the exceptional situation caused by the malfunctioning of the European CO₂ allowances market, the Chaire Economie du Climat (CEC) convened a number of experts with the partners of the 'Carbon Prices and Markets' research initiative. The aim was to share information and analysis in order to: (1) acquire a better understanding of the facts, and (2) contribute to the ongoing general discussion on the search for solutions. This summary provided by the Chair represents its author's opinion only.

1) THE FACTS

Failings of three kinds have led to the freezing of spot market transactions in the European CO₂ allowances market and to a crisis, the severity of which is widely acknowledged.

- VAT fraud involving the purchase of allowances through an account in a foreign carbon registry (thus exempt from VAT, as with all exported products) and then reselling them by charging VAT to local buyers without repaying it to the tax authorities. The unpaid tax probably amounted to several billion euros between late 2008 and summer 2009. This type of fraud is detected by observing cross-border allowances trading, which accelerate as they rotate in a carousel. It does not change the overall equilibrium of supply and demand for allowances.
- CER recycling, resulting from the re-appearance in the EU emissions trading scheme of CERs that have already been used for compliance by installations in the Hungarian registry, but resold by the Hungarian government in the international market. In this case, the environmental integrity of the market is affected: a recycled CER (if it is recycled only once) covers the emission of two tonnes of CO₂.
- Theft of allowances in registries, using well-known cybercrime techniques involving the impersonation of another person in cyberspace ("phishing") or conducting direct attacks ("Trojan horses"). This type of theft probably amounted to around 3 million tonnes of CO₂ in January 2011, or 0.15% of overall emissions allowances, representing some 45 million euros. The fraud is detected when account holders succeed in thwarting attacks or subsequently realize that they have suffered losses. This type of fraud alters the market equilibrium between supply and demand, if the stolen allowances can no longer be used for compliance. It also undermines confidence.

The measures taken by the national authorities and the European Commission have not so far been sufficient to restore confidence.

- VAT fraud. National crisis measures such as changing the VAT rules applying to CO₂ emissions trading or even abolishing it, have stemmed tax fraud in the countries concerned but have been unable to guard against its transfer to other European countries. On 16 March 2010 the European Commission adopted a directive amending the method of levying VAT on CO₂ allowances (the "reverse charge mechanism"). In the absence of the total implementation of this directive, it seems that there still remain a number of havens on European territory for VAT criminals.

- CER recycling. Amendments to the Registries Regulation made in April 2010 (article 53 of the regulations) should guard against the recycling of CERs, which now are held in “retirement accounts” once they have been used for compliance.
- Theft of allowances. To prevent further attacks, on 19 January 2100 the Commission decided to freeze all transactions between registries. Registries are being re-opened on a gradual basis, the Commission authorizing this only when it considers the security level to be adequate (not all the criteria have been made public). On 11 March, 15 registries were authorized to open, though without leading to a significant recovery in spot trading of allowances. As long as there are still weak links in the registry system, one cannot be sure that an allowance purchased on the market has not been stolen, nor indeed whether the thefts have completely stopped.

These various failings of the European carbon market pose a threefold risk.

- Loss of operator confidence, as testified by the ongoing freeze in transactions on the spot market. From this standpoint, the continuation of a significant volume of trading of future contracts is misleading: these contracts cannot be finalized without a restoration of confidence in the “physical” merchandize, in other words confidence in the capacity of every available allowance to authorize the emission of a tonne (and only a tonne) of CO₂. The crucial settlement dates are from this standpoint set by the compliance schedule, even if the rules in force (intra-period borrowing rules) can allow time to be saved.
- Loss of reputation in the eyes of the public, part of which is already sceptical about using the market to combat global warming. For the media, a spicy story of cybercrime or tax fraud is a lot more appealing than explaining the operation of the market and its relevance for reducing emissions in Europe. The average member of the public is thus over-informed about the failings of the system and under-informed about its successes.
- The instrument’s loss of credibility among political decision-makers in Europe and elsewhere. This loss of credibility is fatal: the very existence of the market depends on a commitment to the policy of capping emissions in order to artificially create a scarcity of emission rights.

2) WAYS OUT OF THE CRISIS: STRENGTHENING REGULATION? OVER WHAT TIME FRAME?

To a certain extent, the European emissions trading scheme is a victim of its own success. The development of the market has been too fast for the necessary regulations to be introduced by the authorities. The way out of the present crisis is to be sought, therefore, through strengthening regulation – something on which there is a broad consensus. Three important characteristics should, however, be remembered.

- Decentralization of the European emissions trading scheme was one of the political conditions of its rapid launch in 2005. The Commission deliberately based its supervisory role on what seemed to it to be essential: the specification of caps, the principles governing allocation, the link with the international projects market, etc. It left considerable freedom to member States as regards allocation, management of registries and organization of trading. The political management of the system remains complex, since the 27 member States are far from all being fans of the carbon market. Misgivings are clearly apparent among the ten eastern European countries which recently joined the EU and which were obliged to participate in the emissions trading system under the “acquis communautaire”.
- This decentralisation has resulted in many partial regulations in the carbon market. The rules that apply may vary from one country to another. There are, for example, various definitions of the status of the CO₂ allowance, which is considered to be a financial product in Luxembourg – where it may be incorporated into an investment fund – whereas this is not the case in France. Another consequence of the superimposing of national rules is that using a stolen allowance for compliance is liable to criminal prosecution in some countries such as France, but is not in others such as Germany.
- The strengthening of community supervision of financial markets and products (MiFID Directive) and of market abuse will automatically strengthen the regulation of futures trading already subject to regulation. It will not solve the problem of the security of registries and of monitoring the spot market, which were the main shortcomings underlying the crisis of confidence.

The way out of the crisis does not therefore involve building from scratch a regulatory system suited to the specificities of the carbon market. Rather it requires gradually changing the existing complex hybrid system into one that is more credible.

In the very short term, the return of public confidence means addressing the liabilities inherited from past failings. The re-opening of the 27 registries, with improved security, is a prerequisite. Dealing with the risk associated with holding and using stolen allowances is also necessary.

- The partial reopening of the registries does not ensure a return of confidence. In a market with 27 member States, it is the weakest link in the system that determines its overall reliability. From this standpoint, the checking procedures for opening accounts and the security of access to the weakest registries must be quickly strengthened. For confidence to be restored, the Commission must be able to guarantee the reliability of each and every registry.
- Dealing with risks associated with the use of stolen allowances cannot wait until the 27 member States have harmonized their domestic legal systems. As soon as the registry system is again operational, a formula must be found to identify all stolen allowances (the famous “list”) and to guarantee their risk-free use by operators that have acquired them in good faith in the market. Since allowances can be traced by their serial number, this operation should not present any major technical problems. At the institutional level, however, care must be taken not to create an incentive to make a false “declaration of theft”.

In the medium terms, the issues of strengthening regulations coincide to a considerable extent with those of moving into the third phase. The main novelty will be the implementation of the primary auction market upstream of the secondary market. This development can contribute to greater coordination and centralization of carbon market regulation, though it is not a cure-all. To be effective, it needs to be accompanied by four changes already recommended in the Prada report.

- Legally and fiscally define a CO₂ allowance in a unified way in Europe, the most appropriate definition being “a tradable administrative authorization” that does not fall within the strictly defined field of financial products. Logically this leads to specific carbon market regulation, straddling financial market law on the one hand and energy and competition law on the other.
- Control market access both for derivatives and spot trading with common rules for opening registries in Europe.
- Strengthen “depository infrastructure” both for spot trading (cf. the previous point) and derivatives (central registry). The two branches of the infrastructure should communicate so as to establish a single information system in the long term, ensuring the traceability of all products traded.
- Establish a specific supervisory authority in particular for ensuring the transparency of and access to information relevant to the market and the protection of private information. For example, it is absurd that Internet addresses and background information on installations subject to caps can be found in the registers. In contrast, European registries do not provide real-time information on the volume of transactions between registries, which would allow rapid detection of possible anomalies in spot trade flows.

Given the complexity and inertia of the European institutional system, the greatest difficulty is not deciding what ways out of the crisis there may be in the medium term. It is to make sure that such corrective measures can be taken, within appropriate time-frames, in harmony with steps needed to restore short-term confidence in the market.

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