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# ECA Audit:

# The integrity and implementation of the EU Emissions Trading Scheme

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# Introduction

- What is the EU's Emissions Trading Scheme (ETS) ?
- Risks: how did we identify them and what are they ?
- What did we audit ?
- How did we audit ?
- Main findings and recommendations
- Challenges and lessons learned

# What is the EU ETS ?

- It's the EU's star policy to combat climate change, operational since 2005 (with second phase matching the Kyoto Protocol period to 2012).
- The ETS sets a reducing annual limit on emissions of $CO_2$ and other greenhouse gases by energy intensive sectors which account for around 50% of emissions of $CO_2$ in the EU.
- Installations must be licenced, and they then receive emission allowances (either for free, or, increasingly, by auctions). Each year, installations must surrender allowances to cover their emissions of $CO_2$.
- Allowances can be bought and sold on a multi billion euro market. Most of the market is derivative based.
- As well as reducing overall emissions of greenhouse gases, by establishing a price for, and a market in carbon, businesses should be encouraged to invest in low carbon technologies.

# How did we identify risks ?

Our risk analysis and audit preparation considered:

- Reports from WGEA, SAI’s and national authorities (including Denmark, Finland, Lithuania, Norway, Poland, Sweden, UK, France).
- Consultations with European Commission, UNFCCC, OECD, NGO’s, focused information visits to Member States, and site visits to steel + energy producers.

# What are the main risks ?

### DESIGN RISKS

- Regulatory gaps
- Use of Kyoto Protocol mechanisms leading to oversupply

### IMPLEMENTATION RISKS

- Weak National Allocation Plans
- Poor monitoring by Commission
- Weak monitoring and verification at installations
- Poor supervision by Member States
- Poor implementation of sanctions
- Insecure registration and IT system

### TRADING and other RISKS

- **Theft of allowances**
- Weak market regulation
- **VAT fraud (over 5 billion euro)**

### IMPACT RISKS

- Lack of incentive to reduce emissions
- Windfall profits
- Oversupply

# Risks – an example of theft (*source: Financial Times*)

Financial Times (UK) | Thursday, January 20, 2011 | 34

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## Hackers cast cloud over EU emission trade scheme

**News analysis**

Allowances worth about €7m were swiped from a Czech Republic account, writes **Joshua Chaffin**

The idea behind the European Union's emissions trading system was to put a price on carbon, the purpose being to pressure industry into reducing the amount of greenhouse gases it spews into the atmosphere.

The scheme has drawn plenty of criticism since its launch in 2005 from environmental campaigners and industry executives alike. Now it has suffered another blow. Computer hackers have forced its suspension.

More than a year ago, authorities began to notice that cybercriminals were hacking into the national registries where allowances are stored and stealing them to sell on the open market.

What had seemed an isolated problem has since escalated into a series of attacks in recent months, culminating in the European Commission's decision on Wednesday to suspend trading for at least a week, and possibly longer.

In what is believed to have been the worst attack, allowances worth about €7m were swiped from an account in the Czech Republic on Wednesday. The extent of the delay will depend, in part, on how long it takes the Commission and EU member states, which control the registries, to agree security fixes.

The suspension comes after the recent disclosure of abuse in Germany, where the scheme was exploited to avoid value-added taxes and news of a mishap in Hungary, in which used allowances were reissued. Even if trading resumes quickly, the episode is likely to undermine further a system that has long struggled to live up to policymakers' visions.

"It doesn't help the credibility," said Kjersti Ulset, head of European analysis at PointCarbon, a consultancy. "For those people who are against emissions trading as a tool to reduce greenhouse gas emissions, now they have another argument."

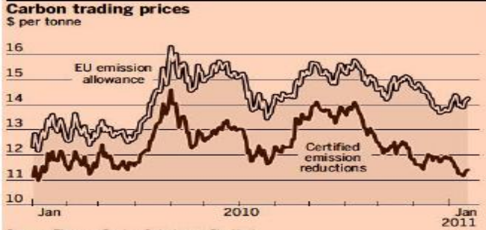
There are plenty of critics. European industry has griped about the scheme, which it believes unfairly punishes heavy manufacturers competing against less heavily regulated companies in China, India and the US.

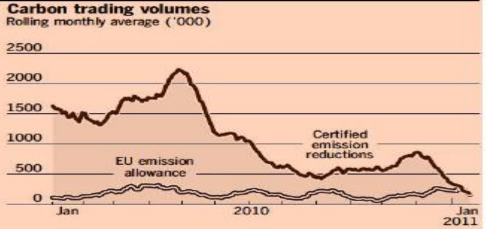
The scheme has disappointed some of its advocates as well. Environmental groups, in particular, have complained that too many allowances were given out for free in the system's early years. As a result, prices have never achieved the levels that policymakers hoped would encourage companies to invest in green technologies of the future.

Some banks, too, remain reluctant to invest in carbon trading desks, while some financial investors, key to providing adequate liquidity for companies to trade in an out of the market, have left the scheme.

Although the EU has tried to improve the situation in recent years by limiting free allowances, the carbon price has languished at about 15 euros per tonne, in part because the economic crisis has damped industrial activity.

Exhaust plumes from Jaenschwalde coal-fired power station in Germany, one of the biggest producers of $CO_2$ in Europe Getty




Sources: Thomson Reuters Datastream; BlueNext

In the first phase, from 2005 to 2007, companies received all of their permits for free. In the current phase, to 2012, some were forced to pay for a proportion of their quota. But most companies have had ample permits to cover their needs. The Commission has proposed that from 2013, power companies should have to buy all of their permits at auction and other heavy industries should have auctioning phased in by 2020.

> 'Those who are against emissions trading as a tool to reduce emissions now have another argument'

The companies trade the permits through climate exchanges, such as France's BlueNext spot emissions exchange, which halted trading on Wednesday. If the companies want to pollute more, they must buy more permits in the market; if they have too many permits because they have cut their emissions, they can sell the surplus.

Ms Ulset speculated that the EU should be able to plug the security holes in the registries where allowances are stored in the same way that banks have secured themselves from cyberattacks.

"You can look at the registries just like a bank, but instead of transferring money from account to account you are transferring allowances," she said.

The EU's governance, though, may not make that so easy. While the commission has drafted the rules for the ETS, it is ultimately the member states that look after their own registries. After attacks last year, the commission recommended that they tighten security. But, facing strained budgets, some have resisted.

After a security breach in Germany in 2010, Jos Delbeke, the head of the EU's climate directorate, warned companies taking part in the system would also have to take measures to ensure their security.

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# Risks – an example of VAT fraud *(source: Le Monde)*

Le Monde.fr | Escroquerie à la « taxe carbone » : prison ferme, amende et millions de dommag…

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LECTURE ZEN

Le financier Arnaud Mimran et Marco Mouly ont été condamnés jeudi 7 juillet à huit ans de prison et 1 million d'euros d'amende par le tribunal correctionnel de Paris pour une escroquerie à 283 millions d'euros à la « taxe carbone ». Le tribunal a ordonné l'incarcération immédiate du premier et a délivré un mandat d'arrêt contre le second, qui n'était pas présent au délibéré.

# What did we audit ?

After much debate our main audit questions focussed on the implementation of phase II of the EU ETS 2008-2012 (Kyoto commitment period):

**Is the EU ETS managed adequately?**

- Is there an appropriate framework for protecting the integrity of the EU ETS?
- Is the EU ETS correctly implemented?

We did not audit impact of ETS or oversupply, as:

- economic crisis was depressing demand;
- it was the right time to examine implementation;
- oversupply and impact were already getting enough attention.

# How did we audit ?

- Interviews and extensive document reviews (e.g. Impact Assessments for MIFID/MAD;)
- Examination of extracts from the ETS Registry;
- Examination of ETS records for 150 installations from 7 Member States;
- Use of expert assistance for the issues concerning market integrity

# Audit findings

**The framework to protect market integrity was still not sufficiently robust,**

- Gaps in regulation of compliance traders, bilateral OTC spot trades, and small market participants;
- No EU oversight of the market;
- Unclear legal definition of allowances;
- Account opening and transaction monitoring procedures were weak;
- Development of the registry was not well controlled.

**… and there were significant implementation weaknesses.**

- Poor assessment of NAP's;
- Incomplete reporting and lack of harmonisation of key controls;
- Question marks concerning national sanctions;

# Main recommendations (mainly to Commission)

**In order to  make the framework to protect market integrity sufficiently robust:**

- gaps in market regulation, regulatory cooperation, and supervision should be addressed, especially in the context of future reviews of MiFID and MAR;
- The legal status of allowances should be clarified;
- Cross border transaction monitoring should be developed;
- Best practices for control of account openings should be promoted;

**In order to address the implementation weaknesses:**

- The monitoring and control framework should be strengthened;
- Better coordination at Member State level was needed;
- Required reports should be published on time;
- Commission monitoring of Member Sate implementation needed improvement;
- Sanctions should be more transparent and consistently applied.

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# Challenges

- Dealing with confidential and market sensitive information at audit and reporting stage;
- Contracting an expert for market integrity issues was necessary, but was time consuming;
- Obtaining and agreeing on the evidence for the market integrity pillar of the audit was a challenge.

# Lessons learned

- Allow sufficient time at the planning stage,  including information visits;
- Communicate early in the process with internal stakeholders on feasibility challenges and their potential impact on the audit scope (avoid trying to ask too big a question!);
- Take the time to address auditee concerns on confidentiality / sensitivity, while retaining independence;
- Timing of publication.

# Thank you

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