



# LEGAL ISSUES RELATING TO TRADING ON THE EU EMISSIONS TRADING SCHEME

## COP/MOP MONTREAL

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# EU ETS – Market Development

## Some Legal Issues

- Key Issues = Certainty and Harmonisation
- Legal character of an EU Allowance
- Tax treatment
  - VAT
  - Corporation Tax
- Insolvency Issues
- Financial services regulation
- Emissions Trading Contracts

# Legal Character of an Allowance – Distinguish from Permits

## Permits

- Site specific
- Non-transferable
- Sets monitoring and reporting obligations
- Sets obligation to hold allowances to match emissions each calendar year
- Issued by 31/3/04

## Allowances

- Issued by MS to operators
- Entitled to emit a tonne of CO<sub>2</sub>e
- Transferable between persons in EU
- Transferable between persons within & outside EU if bilateral agreement
- Held in electronic form in registry system
- European Transaction Log (ETL”)

# Legal Character of an Allowance

- Property Right or Licence to Pollute? Does it matter?

**Property is not a term of art – depends on its circumstances**

*Celtic Extraction Ltd & Bluestone Chemicals v EA [1998] CA*

3 Tests:

- There must be a statutory framework conferring an entitlement on one who satisfies certain conditions even though there are some elements of discretion exercisable with the framework
- The licence must be transferable
- The exemption or licence will have value

## Legal Character of an Allowance (Cont/d.)

- Are Allowances revocable?
- Taking Security over an Allowance – registration, order of priority
- Will an Allowance expire?
- Under-allocation based on submission of erroneous data: operator bears risk
- Over-allocation based on submission of erroneous data: Government to claw-back?
- Commitment Period Reserve: No Guarantee to Account Holders in UK Registry

# TAX

## VAT:

- Allowance classed as supply of services and therefore subject to VAT when traded in on secondary market
- Standard-rated
- No VAT on issuance of Allowance because issue is free of charge
- Trade which relates to delivery of underlying asset (the Allowance) eg. an option or deliverable forward/future will attract VAT
- Trading of Allowance which can never result in delivery of underlying asset (eg. contracts for difference) treated as “financial instrument” and does not attract VAT (classed as exempt financial transactions)

# TAX

## VAT (continued)

- Cross-border transactions – “place of taxation” rules apply
- Decision of EU VAT Committee – 14 October 2004
  - Trade of Allowances subject to reverse charge in buyer's jurisdiction where different to that of seller
- Sale to buyer in same country – seller charges VAT in usual way
- Sale to buyer in different country – seller need not charge VAT – for buyer (if in an EU country) to self-assess at local VAT rate
- Sale to non-EU buyers can be made free of VAT
- Domestic VAT must be self-assessed on purchase from non-EU seller

# TAX

## VAT (continued)

- Ruling eases VAT compliance burden for cross border trading
- However – wholly or partially exempt business will still have VAT recovery blocked or restricted
- VAT rates vary from 15 – 25% - mitigate VAT costs by using VAT registered entity in low VAT jurisdiction?
- Remaining area of uncertainty – VAT status of Allowance auction by central government
  - Most charges by government for permits not subject to VAT
  - Exemption does not apply where it leads to “significant distortion of competition”



# Income Tax, Corporation Tax and Capital Gains Tax

- Variety of types of tax payer – therefore impossible to offer general advice
- Potential tax payers will hold Allowances in different capacities for different reasons such as: trading stock; investments; or fixed assets of a business.
- Different tax treatment for each set of circumstances
- No new UK tax law introduced to deal with EU ETS and/or Allowances

## Stamp Duty

- Allowances unlikely to fall within scope of either stamp duty or stamp duty reserve

# Insolvency

- No specific provisions in ETS Regulations to deal with operators that become insolvent
- Previously considered the following amendments to ETS Regulations:
  - Notification to the Regulator of event of insolvency
  - Deemed surrender of Allowances to cover reportable emissions
- Consultees expressed concern with implementation at the consultation meeting in late 2004
- Government has decided to take time to consider treatment and insolvency further
- No drafts or proposed amendments issued as yet.

# Financial Services Regulations - EU

- Investment Services Directive (93/22/EEC) governs regulation of investment services across EU
- Generally, a company that provides investment services to 3<sup>rd</sup> parties in relation to specified financial instruments will fall within scope of ISD
- Significant divergence of opinion across EU on status of Allowances under ISD
- Therefore differing regulatory regimes from country to country

# Financial Services Regulations - EU

- Markets in Financial Instruments Directive  
MIFID/ISD II (2004/39/EC)
- Sets out a list of Financial Instruments
- Options, futures and other derivatives contracts relating to emissions allowances
- UK Implementation - 2007

# Financial Services Regulations - UK

- Authorisation requirements for regulated activities
- Financial Services and Markets Act 2000  
(Regulated Activities) Order 2001 (“RAO”)
  - Specified Activities
  - Specified Investments
  - Exclusions (overseas persons exclusions)
- FSA Information Note for commodity market participants (October 2004) clarifies UK Regulations position

# Financial Services Regulations - UK

- Are allowances “Specified Investments”?
  - *“Part 3 of the RAO sets out the list of specified investments and an emission allowance or right to pollute does not come within this definition” (FSA)*
  - Trading in emission allowances themselves for immediate delivery is not a regulated activity

# Financial Services Regulations - UK

- Specified Investments
- Futures (Article 84)
- Rights under a contract for the sale of a commodity or property of any description under which delivery is to be made at a future date and at a price agreed on when the contract is made
- Is an allowance a “commodity” or “property”?
  - Chose in action?
  - Property as opposed to a permit to pollute?

# Financial Services Regulations - UK

- *Commercial v Investment*
- Exchange (RIE) traded (investment)
- Delivery within 7 days (commercial)
- One or more parties in a producer of the commodity or property or uses it in business (commercial)
- Seller delivers or intends to deliver the property (commercial)
- Buyer takes or intends to take delivery (commercial)
- Individually negotiated contracts: prices, the lot, the delivery date or other terms are determined by the parties for the purposes of the particular contract (commercial)



# Financial Services Regulations - UK

- Options (Article 83)
  - To acquire or dispose of a security, contractually based investment, currency, precious metals
  - Option to acquire an allowance does not fall within Article 83 definition
  - Option over an allowance future will fall within definition
- MIFID
  - “Options, futures...and any other derivative contracts relating to...emission allowances”
  - Options over allowances will be caught under MIFID transposition

# Financial Services Regulations - UK

- Contracts for differences (Article 85)
- A contract for differences
- Any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuation, in (i) the value or price of property of any description; or (ii) a factor designated for the purpose
- Exclusion for contracts where there is delivery of the underlying asset

# Financial Services Regulation - UK

- Regulated Activities Exclusions
- Dealings as principal with or through an authorised person (Article 16 RAO)
- Risk Management (Article 19 RAO)
  - Businesses which do not involve carry on of financial services/banking
  - Sole or main purpose of transaction
  - Limiting extent to which business will be affected by any identifiable risk
  - Arising otherwise than as a result of carrying on a regulated activity

# Emissions Trading Contracts

## Developing A European Standard Document

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graph TD; A[Developing A European Standard Document] --> B[PROMOTING MARKET LIQUIDITY]; A --> C[REDUCE TRANSACTION COST AND TIME]; A --> D[PROMOTE CERTAINTY OF TRADING TERMS];
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PROMOTING MARKET  
LIQUIDITY

REDUCE TRANSACTION  
COST AND TIME

PROMOTE CERTAINTY OF  
TRADING TERMS

# IETA/EFET/ISDA Contract Comparison

## Baker & McKenzie Comparison Analysis

- Agreements Covered
  - EFET Allowance Appendix (version 1.0 published March 2004) to the EFET Agreement concerning Delivery and Acceptance of Electricity (version 2.1 published 20 December 2000)
  - IETA Emissions Trading Master Agreement for the EU Scheme (version 2.0 published 2004)
  - Confirmation of OTC Physically Settled EU Emissions Allowance Transaction published by ISDA which is intended to supplement one of the ISDA Master Agreements (published in 1992 or 2002)

# IETA/EFET/ISDA Contract Comparison

## Overview & Conclusions

- Consider impact of:
  - Emission Trading Specific Issues
    - Excess Emissions Penalty provisions
    - Differences in basic mechanics e.g. payment and delivery dates
    - Differences in the Force majeure / settlement disruption/ failure to deliver provisions and consequences e.g. compensation payable
    - Effect of changes to scheme

# IETA/EFET/ISDA Contract Comparison

## Overview & Conclusions ...continued

- Consider impact of:
  - General Master Agreement Issues
    - Differences in the other events of default or termination events
    - Differences in the calculation of any termination payments
    - Differences in termination proceedings e.g. some or all Transactions?
    - Payment netting and close-out netting enforceability
    - Clauses in some agreements but not in others e.g. Confidentiality
    - Boilerplate differences e.g. Assignment, Dispute Resolution

## Harmonisation Efforts

- Commenced in February 2005
- Goal = Harmonise contracts to reduce basis risk
- Harmonisation possible on many points (but not all)
- ‘Standardised optionality’
- New (revised) documents published by IETA, ISDA and EFET in June/July 2005



# Overview of Material Provisions

- When everything runs smoothly
  - force majeure
  - billing and payment
  - settlement netting
- When something goes wrong
  - failure to deliver/accept
  - primary delivery obligation
  - dispute resolution

# Physical Netting of Deliveries

- IETA clause 8.7 (ISDA Part [6](c)(i)(2); EFET §4.3)
- Summary: If on any date (1) Allowances of same Allowance Type and Compliance Period, are (2) deliverable in respect of 2 or more Transactions, between (3) accounts in the same Registry or between a Registry Pair, then each party's delivery obligation is automatically satisfied and discharged, and replaced with obligation on party who originally owed larger number of Allowances to deliver excess of larger amount over smaller amount
- Residual differences
  - Application automatic under ISDA, elective under IETA (fallback = applicable) / EFET (fallback = not applicable)

# Failure to Deliver – EEP and EEP Equivalent

- IETA clause 6.1.2, paragraph (b) of definition of “Buyer’s Replacement Cost” and definitions of “EEP Amount” and “Buy-In” (ISDA Part [6](c)(ii)(1)(A) and paragraph (ii) of definition of “Buyer’s Replacement Cost”; EFET §8.3 and definitions of “EEP” and “EEP Equivalent”)
- Summary: Where the parties have elected EEP to apply, if Seller fails to make Transfer, Buyer may require Seller to remedy failure. If remedied within 1 Delivery Banking Day, Buyer pays for Allowances and Seller pays Buyer interest on component of Contract Amount applicable to Allowances not delivered by original Delivery Date. If not remedied, Buyer may terminate Transaction. If Buyer does terminate, Seller must pay Buyer’s Replacement Cost; provided that Buyer is obligated to mitigate loss by, among other things, effecting a Buy-In (if possible).
- Residual differences
  - ISDA does not currently provide any method for calculating Buyer’s Replacement Cost where EEP is elected to apply (but ISDA currently working on appropriate language – see Current Market Developments)
  - Fallbacks different: IETA = EEP not applicable, but if elected to apply, fallback = EEP equivalent also applies; ISDA = not applicable; EFET = EEP and EEP Equivalent applicable

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