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Tax Fraud from Emissions Trading in the European Union

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Issue

The European Union Emissions Trading Scheme (EU ETS) began in 2005 as the largest multi-country and multi-sector greenhouse gas emissions trading system in the world by volume of units traded. European Union Allowance certificates (EUAs) are traded within the system in order to meet with emissions reduction policy set by the European Union (EU). Since its introduction the EU ETS, a market now worth $100 billion[i], has been the target of significant levels of tax fraud. In Romania, financial regulators through the National Securities Commission (NSC), recently classified EUAs/carbon credits as financial instruments, thereby eliminating any over the counter (OTC) trading of the assets. All dealing must now go through the national exchange in order to comply with the provisions for the Romanian capital markets legislation, which regulators say will remove the possibility of continued abuse of the tax system. The benefits of removing tax fraud are clear; however there has been some debate around the appropriateness, and indeed the legality, of the response from Romania. Critics argue that the national legislation in this area should be aligned with EU regulations, because the mechanism to reduce greenhouse gas emissions and trade carbon credits certificates is established at a European level. This brief considers the issue of tax fraud within an emissions trading scheme, notes other key factors required for a solution, and considers implications for BC's own emissions trading scheme which will come into effect in 2012 as part of the Western Climate Initiative (WCI).

Background

The European carbon market is fragmented: up to 10 different exchanges trade carbon credits. Carbon credit futures are the staple of the EU market and are already considered financial instruments throughout Europe. Independent deals conducted through the over-the-counter (OTC) market—which is composed of brokers and traders scattered across the EU's 27 member states—are not transacted on an exchange and make up a significant portion of the total trade in emissions allowances. Carbon credits traded on the spot market or OTC are normally considered ordinary goods that command value added tax (VAT) when traded. The fraud occurs when fraudsters sell carbon credits and collect the accompanying VAT, but disappear before the money is handed over to the revenue collector. This tax avoidance is known as carousel fraud because the fraudster can repeat the process many times over. Europol estimates VAT fraud has cost the EU 5 billion Euros in lost tax revenue in the last 18 months alone. It is estimated that in some countries, up to 90% of the whole market volume was driven by fraudulent activitiesii. In contrast, when traded on an exchange, carbon credits securities become tax-exempt, thereby removing the opportunity for abuse. The ruling by Romania's National Securities Commission (RNSC) prevents foreign firms from trading carbon credits in Romania without joining the Sibiu Monetary-Financial and Commodities Exchange (SIBEX), currently the only Romanian exchange licensed to trade carbon credits. SIBEX has just 38 authorized members meaning that foreign traders can no longer conduct transactions in Romania with carbon credits unless they become members of SIBEX. Authorities say this will facilitate transactions between Romanian operators and foreign partners. However, emissions traders in Eastern Europe say the unilateral ruling may be illegal under the EU's ETS as it effectively rules out OTC and broker-to-broker trading.

Critique of options for action

There are some important points to consider when looking at Romania's response to carbon credit tax fraud, and the effectiveness and efficiency of exchange-only transactions or OTC transactions.

Exchange only transactions:

Benefits

- Increased transparency through centralised, standardised, electronic trading, provided that exchanges are required to take preventive measures and regulators are authorised to protect markets from abuse
- Market regulators have more direct access to information
- Virtual absence of counterparty risk
- The market is more liquid in nature than the OTC market
- Increased speculation can be curbed to some degree through position limits
- Cash settlement and clearing services lower the risk of default and limit the potential for negative knock-on effects if default occurs

- Facilitates price discovery between market participants and encourages competitiveness
- Increased trading volume and revenue are generated for the exchange when transactions are shifted from OTC to the exchange

Drawbacks

- Only standardised contracts are offered, eliminating deal flexibility
- Significant collateral requirements make it difficult for some important market players to participate. Electricity utilities are typically the largest emitters and are therefore required to transact more permits in the market than anyone else. This volume of trade is accompanied by significant collateral requirements
- Trading may not be of sufficient volume to justify infrastructure costs necessary to accommodate the market

Adding OTC transactions:

Benefits:

- Contracts can be customised more precisely to a company's specific risk management needs which provides greater flexibility
- A wider array of assets can be used as collateral for transactions. This is particularly useful to participants who look to minimise their carbon risk over a period of decades while maintaining significant cash resources for infrastructure investments
- More accommodating of offset contracts where the volume and timing of future credits can be uncertain due to factors such as project approval, verification, and performance

Drawbacks

- Potential for fraudulent activities and system abuse
- Overall costs of fraud

Recommendations

The primary reason for the tax fraud issues in the EU is the lack of oversight in the market. In developing the most effective carbon market, lawmakers and regulators have several options for improving oversight of exchange based and OTC trading:

- Imposition of position limits
- Clearing and collateral requirements
- Defined reporting obligations
- Restrictions on participation in certain types of transactions[iii]

OTC markets are more difficult to monitor due to their decentralisation and traditional lack of transparency. The challenge for regulators is to establish in OTC markets the type of requirements found on exchanges. Both OTC and exchange based systems have roles to play in a regulated carbon market, and it should be possible to maintain a role for OTC transactions while ensuring an appropriate level of regulatory oversight and efficient market operation. The challenge faced by lawmakers and regulators is to strike the right balance between market transparency and oversight, and the ability of market participants to structure contracts that best fit their particular needs. The first phase of the Western Climate Initiative Cap and Trade Program comes into effect on January 1, 2012. The emissions allowances issued and traded under the scheme will be subject to applicable regional and national tax structures. As the WCI emissions trading market develops, some allowances will be traded on an exchange, and some via OTC transactions. As a result, BC may face similar challenges to protect against tax fraud as those faced by regulators in the EU, and should therefore be prepared to tackle this issue pre-emptively before the launch of the system.

Further Reading

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http://www.risk.net/energy-risk/news/1593479/romania-bans-otc-emissions-trading-combat-fraud

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[i] Reuters Carbon Market Community, February 2010: *Ruling kills Romanian OTC Carbon permit trading*

[ii] Europol Press Release, 9 December 2009: *Carbon credit fraud causes more than 5 billion Euros damage for European taxpayer*

[iii] Point Carbon - Carbon Market North America, March 5, 2010: *Carbon Market Oversight and Regulation* by Janet Peace and Timothy Juliani of the Pew Center on Global Climate Change