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ReedSmith

Energy Trade & Commodities Alert

Emissions Trading: Bulgaria gets the Boot!

Greenhouse gas emissions trading[1] ("Emissions Trading") has been in the news frequently over the past few months and the developing market continues to face numerous regulatory and commercial challenges during 2010. The way in which the market reacts to these issues will shape Emissions Trading in the years to come.

Recent issues include the failure to reach a new international climate change accord in Copenhagen to replace the Kyoto Protocol (the "Protocol"), VAT carousel fraud, the phishing of EU Allowances, "recycling" of CERs[2] in Hungary and the uncertainty surrounding the key aspects of Phase III of the European Union Emissions Trading Scheme ("EU ETS").

The latest crisis arose with the preliminary finding[3] by the UN that Bulgaria was in non-compliance with the Protocol. This finding has been confirmed by the UN's final decision[4], released on 28 June 2010, which also decides that as a result of its non-compliance, Bulgaria is to be suspended from trading Emissions under the Protocol. This is significant and has only happened on one occasion previously with Greece being suspended for 7 months in 2008 (however at the time Greece was suspended, the systems linking the EU ETS and the Protocol were not fully operational and therefore there was little impact on the EU ETS).

In this client alert we review the background to Bulgaria's suspension and we examine the impact this may have on the EU ETS.

Brief Summary of the Kyoto Protocol

Before examining the issues around Bulgaria's suspension, it is useful to briefly outline the Emissions Trading regime under the Protocol and how this links with the EU ETS.

The Protocol was adopted on 11 December 1997 and entered into force on 16 February 2005. It sets binding targets for 37 developed countries in addition to the European Union for the reduction of Emissions.

The EU has implemented the EU ETS to meet its obligations under the Protocol. Under the EU ETS, large EU-based emitters of Emissions ("Installations") are required to report Emissions on an annual basis to its national government and at the same time return a number of permits ("Allowances") equal to the amount of Emissions emitted in that year. Under the current EU ETS rules, Installations are allocated a number of free Allowances at the start of each year which are tradable with other participants in the EU ETS. The underlying policy objective of this approach is that those Installations which are the most green will be able to sell their excess Allowances, thereby creating a market based incentive to reduce the amount of Emissions emitted.

Allowances traded under the EU ETS are classified as a specific Kyoto unit which are valid for trading under the Protocol and are recorded automatically as Protocol transactions.

Bulgaria's Suspension

On 13 May 2010 Bulgaria's Environment Minister, Nona Karadzhova, announced that the UN had taken preliminary steps to suspend Bulgaria from Emissions trading under the Protocol from the end of June. These preliminary steps were affirmed by the Kyoto Compliance Committee, Enforcement Branch ("Enforcement Branch") on 28 June 2010.

Any country wishing to trade any form of Kyoto units must meet the eligibility criteria in Article 17 of the Protocol. The requirements of Article 17 are lengthy and include an obligation to have a functioning registry system and also an audited national inventory. The UN had recommended changes to Bulgaria's processes as far back as 2007 after it found that Bulgaria's national recording verification system for Emissions Trading failed transparency and reliability tests, but the country failed to adequately remedy the deficiencies eventually leading to the suspension. The reporting and auditing system employed by a country is one of the central facets of carbon trading under the Protocol and underpins the entire trading system. It is therefore of no surprise that the UN has taken this action especially given the amount of time in which the Bulgarian government has had to remedy the problems.

As part of its affirmation of the earlier decision of non-compliance the Enforcement Branch has now: (1) formally declared Bulgaria to be in non-compliance; (2) required Bulgaria to submit a plan to address the non-compliance within three months (which will be reviewed and assessed by the Enforcement Branch); and (3) revoked Bulgaria's eligibility to participate in the market mechanisms for Emissions trading so long as the non-compliance exists.

Implications for the EU ETS

The suspension will prevent Bulgarian Installations from trading Emission schemes under the Protocol, and will also have a limited knock-on effect on the EU ETS.

The suspension will be felt the hardest by Bulgarian Installations which, as a result of the revocation of Bulgaria's eligibility, will no longer be able to sell their allocation of Allowances and are prevented from entering into any other cross-border transactions until the suspension is lifted. This is a particular blow to Bulgaria as it is a new entrant to the EU ETS and it was only last month that the European Commission approved Bulgaria's 2009 – 2012 National Allocation Plan which allowed the country to join the EU ETS.

It is likely that the suspension will only have a limited effect on the EU ETS as it will only temporarily prevent the *delivery* of Allowances, meaning that Allowances can not be moved to and from the Bulgarian Registry. This will obviously impact the spot market in particular as Allowances cannot be delivered until the suspension is lifted. In turn, this might have an impact on price and liquidity (though this is unlikely due to the fact that Bulgaria is a relatively new EU ETS market entrant and is not yet a significant trader). The suspension should not, however, affect trading between Bulgarian Installations using only the Bulgarian Registry.

As a potential solution, it is possible for Bulgarian Installations to open an Emissions Trading account in another member state in order to continue trading as part of the EU ETS during the suspension. However if the suspension continues beyond April of next year, problems may arise as these Installations will not be able to surrender credits from their new (foreign accounts) to their Bulgarian Registry accounts (for compliance purposes) as there will be no link between the International Transaction Log and the Bulgarian registry.

We will not know the true impact of the suspension until we get a clear indication from the Bulgarian government as to when their systems *will* be back online. If this situation continues for an extended period then the impact for Bulgarian traders will be much more significant as the futures and forward markets will also be impacted in addition to the spot market.

Impact on Documentation

Depending on the form of documentation which you have in place with your Bulgarian counterparties, the suspension of Bulgaria, and the subsequent inability of Bulgarian Installations to transfer their Allowances out of the national Bulgarian registry to their counterparties' registry, may constitute a "suspension event" under your contract.

The different standard form Emissions trading contracts (ISDA/EFET/IETA) all have slightly differing suspension event mechanics which are frequently modified by parties. It is important to review your agreements at this stage in order to assess what impact this issue will have under your documentation. This is especially pertinent to non-Bulgarian traders which have positions with Bulgarian Installations where forward trades are due to settle during the suspension period.

What will happen next?

The Bulgarian government has tried to reassure the market that it is working hard to ensure that its systems comply with the Protocol requirements and has stated that this should be completed by November 2010. The government has a significant incentive to end the suspension as soon as possible as it has recently announced that it plans to sell 30 million allowances in 2010 – it will only be able to do this should the suspension be lifted.

In the meantime it remains to be seen whether, over the longer term, Bulgaria's suspension will have any material impact on the EU ETS. The saga will help to focus the minds in other Member States that the systems underlying the EU ETS are an essential element of the Protocol and that the Enforcement Branch will take strong measures to remedy non-compliance.

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1. For the purposes of the EU ETS Phase I and Phase II, the emissions trading regime covered primarily CO_2 ("Emissions"). Under Phase III however, the net will be widened to include other gases and also other industries such as aviation and possibly shipping if the International Maritime Organisation's review process is not finalised by 2010.
2. CERs are Carbon Emission Reduction units issued by the Clean Development Mechanism Executive Board under the rules of the Protocol.
3. Dated 12 May 2010
4. http://unfccc.int/files/kyoto_protocol/compliance/questions_of_implementation/application/pdf/cc-2010-1-8-bulgaria-eb_final_decision.pdf

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