EN 2015

NO 06

Special Report

The integrity and implementation of the EU ETS

EUROPEAN COURT OF AUDITORS

EUROPEAN COURT OF AUDITORS
12, rue Alcide De Gasperi
1615 Luxembourg
LUXEMBOURG

Tel. +352 4398-1

E-mail: eca-info@eca.europa.eu
Internet: http://eca.europa.eu

Twitter: @EUAuditorsECA
YouTube: EUAuditorsECA

More information on the European Union is available on the Internet (http://europa.eu).

Luxembourg: Publications Office of the European Union, 2015

Print	ISBN 978-92-872-2398-2	ISSN 1831-0834	doi:10.2865/8727	QJ-AB-15-005-EN-C
PDF	ISBN 978-92-872-2367-8	ISSN 1977-5679	doi:10.2865/40845	QJ-AB-15-005-EN-N
EPUB	ISBN 978-92-872-2362-3	ISSN 1977-5679	doi:10.2865/615002	QJ-AB-15-005-EN-E

Printed in Luxembourg

EN 2015

NO 06

Special Report

The integrity and implementation of the EU ETS

(pursuant to Article 287(4), second subparagraph, TFEU)

Audit team

The ECA's special reports set out the results of its performance and compliance audits of specific budgetary areas or management topics. The ECA selects and designs these audit tasks to be of maximum impact by considering the risks to performance or compliance, the level of income or spending involved, forthcoming developments and political and public interest.

This performance audit was produced by Audit Chamber I — headed by ECA Member Augustyn Kubik — which specialises in preservation and management of natural resources spending areas. The audit was led by ECA Member Kevin Cardiff, supported by Mary Kerrigan, head of private office; Gediminas Macys, attaché of private office; Colm Friel, head of unit; Emese Fésűs, team leader; Stefan den Engelsen, deputy team leader; Marco Dentamaro, auditor; Andreas Dürrwanger, auditor; María Luisa Gómez-Valcárcel, auditor; Laura Gores, auditor; Joanna Kokot, auditor; Loulla Puisais-Jauvin, auditor; Frédéric Soblet, auditor and Anna Zalega, auditor.

From left to right: S. den Engelsen, E. Fésűs, K. Cardiff, C. Friel.

Contents

Contents

Abbreviations

AAR: Annual Activity Report

CDM: Clean development mechanism

CER: Certified emission reduction

CF: Compliance Forum

CO_2: Carbon dioxide

CO_2e: Carbon dioxide equivalent

DG: Directorate-general

EA: European Cooperation for Accreditation

EEA–EFTA: European Economic Area–European Free Trade Association

ERU: Emission reduction unit

ETS: Emissions Trading System

EU ETS: European Union Emissions Trading System

EUA: European Union allowance

EUTL: European Union Transaction Log

GHG: Greenhouse gas

IPCC: Intergovernmental Panel on Climate Change

IPPC: Integrated Pollution Prevention and Control

JI: Joint implementation

KYC: Know your customer

MAD: Market abuse directive

MAR: Market abuse regulation

MIFiD: Markets in financial instruments directive

MRG: Monitoring and reporting guidelines

Abbreviations

NAP: National Allocation Plan

OTC: Over-the-counter

UNFCCC: United Nations Framework Convention on Climate Change

VAT: Value added tax

Glossary

07

Account holder: Account holder[1] is a natural or legal person that holds an account in the Union Registry.

Allowance: Under the European Union Emissions Trading System (EU ETS), one European Union Allowance (EUA) corresponds to the right to emit 1 tonne of carbon dioxide equivalent during a specific period (CO_2e)[2]. European Union Allowances can be used by operators within the EU ETS to cover their verified emissions or can be traded with other operators in need of EUAs.

Back-loading: As a short-term measure, the Commission postponed the auctioning of 900 million allowances until 2019–20 to allow demand to pick up[3]. The overall volume of allowances to be auctioned in phase III does not change because of this back-loading; only the distribution of auctioned allowances over the 2013–20 period (the 'auction time profile') changes. The back-loading of auctions is implemented through an amendment to the EU ETS Auctioning Regulation[4] adopted by the Commission in 2014, following approval by the EU Climate Change Committee and scrutiny by the European Parliament and Council. An amendment was also made to the EU ETS directive in 2013 to clear the way for this amendment[5].

Cap-and-trade: The EU ETS is considered to be a 'cap-and-trade' system. This means that there is a 'cap', or limit, on the total amount of allowed emissions by the installations covered in the system. In phases I and II of EU ETS, the caps were set at national level, with approval from the Commission. For phase III, the cap is set at EU level. Within the cap, industry companies and aircraft operators receive emission allowances which they can sell to or buy from one another as needed. Voluntary traders can also enter the market to buy and sell allowances. The limit on the total number of available allowances ensures that they have a value.

---

1 Article 3 of Commission Regulation (EU) No 389/2013 of 2 May 2013 establishing a Union Registry pursuant to Directive 2003/87/EC of the European Parliament and of the Council, Decisions No 280/2004/EC and No 406/2009/EC of the European Parliament and of the Council and repealing Commission Regulations (EU) No 920/2010 and No 1193/2011 (OJ L 122, 3.5.2013, p. 1).

2 Article 3 of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC (OJ L 275, 25.10.2003, p. 32).

3 European Commission, DG Climate Action: http://ec.europa.eu/clima/policies/ets/reform/index_en.htm

4 Commission Regulation (EU) No 176/2014 of 25 February 2014 amending Regulation (EU) No 1031/2010 in particular to determine the volumes of greenhouse gas emission allowances to be auctioned in 2013–20 (OJ L 56, 26.2.2014, p. 11).

5 Decision No 1359/2013/EU of the European Parliament and of the Council of 17 December 2013 amending Directive 2003/87/EC clarifying provisions on the timing of auctions of greenhouse gas allowances (OJ L 343, 19.12.2013, p. 1).

Glossary

08

Central administrator: According to the ETS directive[6], the central administrator is designated by the Commission to maintain an independent transaction log recording the issue, transfer and cancellation of allowances, also conducting an automated check on each transaction to ensure there are no irregularities in the issue, transfer and cancellation of allowances. The registry regulation specifies that the central administrator operates and maintains the Union Registry[7].

Clean Development Mechanism (CDM): CDM projects under the Kyoto Protocol involve investments in sustainable development projects in developing countries to reduce emissions. These generate tradable certified emission reductions (CERs). These so-called credits are allowed, under certain conditions, for use under the EU ETS.

Competent Authority: Member States appoint a Competent Authority or authorities for the implementation of the rules of the EU ETS directive.

Greenhouse gas (GHG) emissions: The atmospheric gases held responsible for causing global warming and climate change. The major GHGs are carbon dioxide (CO_2), methane (CH4) and nitrous oxide (N20). Less prevalent — but very powerful — greenhouse gases are hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF6)[8].

Harmonised allocation rules: In phase III of the EU ETS, the Commission developed harmonised allocation rules[9], with benchmarks per product based on the average greenhouse gas emission performance of the top 10 % performing installations in the EU. The benchmarks are calculated independently of the applicable technology, fuel, size of the installation or its geographical location.

Installation: An installation is a stationary technical unit[10] where one or more activities emitting GHG gases are carried out and any other directly associated activities which have a technical connection with the activities carried out on that site and which could have an effect on emissions and pollution.

Joint implementation (JI): Together with CDMs, this is one of the two project-based mechanisms introduced under the Kyoto Protocol. Industrialised countries carry out joint implementation projects for emission reductions with other developed countries to generate tradable emissions reduction units (ERUs) which can be used, under certain conditions, within the EU ETS.

Kyoto Protocol mechanisms: The Kyoto Protocol (see ***Box of the Annex*** for more details) introduced three mechanisms that can be used to achieve the emission reduction targets: emissions trading, clean development mechanisms (CDM) and joint implementation (JI). Emissions trading allows countries that have unused emission units to sell these to countries exceeding their caps. JI and CDM are project-based mechanisms that generate credits which can be traded to offset emissions.

6 Article 20 of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC (OJ L 275, 25.10.2003, p. 32).

7 Article 4 of Commission Regulation (EU) No 389/2013.

8 Glossary of climate change acronyms, United Nations Framework Convention on Climate Change (UNFCCC).

9 Commission Decision No 2011/278/EU of 27 April 2011 determining transitional Union-wide rules for the harmonised free allocation of emission allowances pursuant to Article 10a of Directive 2003/87/EC of the European Parliament and of the Council (OJ L 130, 17.5.2011, p. 1).

10 Article 3 of Directive 2003/87/EC.

Glossary

Market abuse directive and regulation (MAD/MAR): The initial market abuse directive of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (Directive 2003/6/EC) was repealed and replaced by new rules adopted in 2014. These are Regulation (EU) No 596/2014 on market abuse (MAR)[11] and Directive 2014/57/EU on criminal sanctions for market abuse (MAD)[12]. The market abuse regulation enters into application in July 2016 and Member States have 2 years to transpose the new directive[13] into national law.

Markets in financial instruments directive (MiFID): The initial markets in financial instruments directive of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (Directive 2004/39/EC) was repealed and replaced by new rules adopted in 2014. These are the new Directive 2014/65/EU on markets in financial instruments and Regulation (EU) No 600/2014 on markets in financial instruments. The new rules will be applicable from January 2017[14].

National Administrator: The National Administrator is the entity responsible for managing on behalf of a Member State a set of user accounts under the jurisdiction of a Member State in the Union Registry.

Operator: Any person[15] who operates or controls an installation or, where provided for in national legislation, to whom decisive economic power over the technical functioning of the installation has been delegated.

OTC: The term over-the-counter (OTC) describes all financial market transactions that are not traded on an exchange, nor executed on a regulated market, but instead privately negotiated between two counterparts.

Secondary market: A market where investors buy securities or assets from other investors and not from the issuer.

Spot market: A market where securities or commodities are traded for immediate delivery, as opposed to a futures market.

Surrendering of allowances: By 30 April each year, the operator of each installation is required to surrender a number of allowances equal to the total of verified emissions from that installation during the preceding calendar year[16]. Under the EU ETS in phase II, operators may also, subject to certain limitations, surrender international credits (CERs and ERUs) generated by Kyoto Protocol mechanisms (CDM and JI). In total, the operator must surrender sufficient EUAs, CERs and ERUs to cover its verified emissions.

---

11 Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC (OJ L 173, 12.6.2014, p. 1).

12 Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive) (OJ L 173, 12.6.2014, p. 179).

13 http://ec.europa.eu/finance/securities/index_en.htm

14 Ibid.

15 Article 3 of Directive 2003/87/EC.

16 Article 12(3) of Directive 2003/87/EC.

Glossary

10

Tonne of CO_2 equivalent (CO_2e): Means one metric tonne of carbon dioxide or an amount of any other greenhouse gas with an equivalent global-warming potential[17].

Transaction: A transaction is a process[18] in the Union Registry that includes the transfer of an allowance or Kyoto unit from one account to another account.

Union Registry: The registry is an electronic system which keeps track of the ownership of allowances. The central administrator[19] operates and maintains the Union Registry. The registry[20] is accessible to the public and contains separate accounts to record allowances held by each person to whom and from whom allowances are issued or transferred. In the Union registry any person may hold allowances.

Value added tax (VAT) reverse charge mechanism: This mechanism involves shifting the tax liability from the supplier to the recipient, meaning that the customer, when he is identified as a taxable person, would be liable to pay the VAT instead of the supplier. It is likely that a reverse charge system would eliminate VAT carousel fraud.

17 Annex II of Directive 2003/87/EC.

18 Article 3 of Commission Regulation (EU) No 389/2013.

19 Article 4 of Commission Regulation (EU) No 389/2013.

20 Article 19 of Directive 2003/87/EC.

Executive summary

I

The European Union's Emissions Trading Scheme (EU ETS) is the EU's flagship policy to combat climate change. It is the world's largest cap-and-trade system for greenhouse gas (GHG) emissions. A limit, or cap, was placed on overall emissions from high-emitting industry sectors, which is reduced over time. The cap restricts emissions of more than 11 000 energy-intensive installations across the EU, covering around half of GHG emissions. These installations receive emission allowances or buy them at auctions, and can also trade allowances as needed. Each allowance represents the right to emit 1 tonne of carbon dioxide (CO_2) equivalent. Each year, installations must surrender allowances equivalent to the amount of carbon dioxide equivalent (CO_2e) emitted.

II

The EU ETS is often quoted as the reference model for emerging climate change policy and emissions trading schemes elsewhere in the world. This innovative scheme introduced in 2005 and progressively improved is now in its third phase of implementation. At European level, the environmental goal of the EU ETS is not just reducing emissions in line with the cap, but also putting a price on carbon and giving a financial value to each tonne of CO_2e saved. The price is determined by the market in allowances. This encourages installations to apply the most cost effective emission reduction measures, and promotes investment in low-carbon technologies, particularly if prices of allowances are high.

III

For the EU ETS to work as intended, it is necessary that the integrity of the system is ensured, and that the scheme is correctly implemented. The Court assessed whether the European Union Emissions Trading Scheme was managed adequately, by examining whether an appropriate framework was established for protecting its integrity as a market-based mechanism, as well as examining its actual implementation. As regards the implementation, the Court focused on phase II of the EU ETS (2008–12) so that lessons can be learned for the future developments of this policy.

IV

Overall the Court concluded that the management of the EU ETS by the Commission and Member States was not adequate in all respects. It was hindered by certain issues related to the robustness of the framework for protecting its integrity, and by significant weaknesses in the implementation of phase II of the EU ETS.

V

There have been significant improvements to the framework for protecting the integrity of the system, notably through the inclusion of most of the spot market for allowances under the markets in financial instruments directive (MiFID) and market abuse (MAD (market abuse directive)/MAR (market abuse regulation)) regimes by the qualification of emission allowances as financial instruments. However a number of issues should still be addressed in order to make the framework sufficiently robust, to provide better regulation and supervision, and to encourage investor confidence, in order to leverage the EU ETS as a tool of environmental policy.

(a) There are remaining issues regarding the regulation and oversight of the emission market related to compliance traders, bilateral over-the-counter (OTC) spot trading and smaller market participants.

(b) There is no EU level oversight of the emissions market, and there is insufficient regulatory cooperation.

(c) The legal definition of emission allowances is not sufficiently clear and there is also a lack of clarity regarding the creation and protection of security interests in allowances.

(d) The Union Registry processes fundamental EU ETS data and has a high risk profile due to the financial stakes and wide range of account holders. While the security of the registry has been significantly improved during phase II of the EU ETS, there is still need for further progress. Member State procedures to control the opening of EU ETS accounts, monitor transactions, and cooperate with regulatory authorities had significant shortcomings and the Commission cannot adequately monitor transactions due to data protection considerations. Furthermore the development and operation of the Registry at the Commission was hindered by internal coordination issues and resource constraints, as described in paragraphs 39 to 41.

VI

There were significant weaknesses in Member States' and the Commission's implementation of the EU ETS control framework in phase II. These need to be addressed during phase III so that there is sufficient assurance that the system is operating as intended.

(a) Systems for monitoring, reporting and verification of emissions were not sufficiently well implemented or harmonised. Competent Authorities did not adequately check the work performed by verifiers, and performed limited on-the-spot checks at installation level.

(b) There were gaps in the Commission's guidance and monitoring of Member States' implementation during phase II of the EU ETS, and the assessment of Member States' phase II National Allocation Plans (NAPs) by the Commission was not sufficiently transparent.

(c) Some Member States did not provide all the required reports on the operation of the EU ETS, and the Commission did not publish the annual implementation report required under the EU ETS directive.

(d) The impact of valuable consultation and coordination fora between the Commission and Member States was limited due to the low level of participation by Member States.

(e) The Commission has had a limited role in ensuring the harmonisation of key controls in the implementation of the EU ETS by Member States.

(f) The Court could not assess the effectiveness of the Member States' diverse sanction systems due to a lack of consolidated information at Member State and European level. There were divergent practices concerning specific rules for the surrendering of international project credits between the Member States. These issues potentially affect the level playing field for operators.

VII

In order to address the observations described above, concerning the framework for protecting the integrity of the system and its implementation, the Court makes the following recommendations.

1. Remaining issues in emission market regulation and oversight should be addressed by the Commission in order to further improve market integrity (see detailed Recommendations 1(a) to (c) to the Commission, following paragraph 91).

2. The legal status of allowances should be further clarified in order to contribute to stability and confidence (see Recommendation 2 following paragraph 92).

3. Certain aspects of the systems for processing fundamental EU ETS information (the EU Union Registry and related procedures) should be further improved. In particular the Commission should consider how effective monitoring of cross-border transactions can be developed and coordinated at EU level to mitigate risks of abuse and fraudulent activities, and identify appropriate measures to enhance the control framework and promote best practices by Member States on account opening across the EU. The Member States should ensure that these controls are implemented (see detailed Recommendations 3(a) to (e) to the Commission and the Member States, following paragraph 93).

4. The control framework at the level of the Member States should be better applied to ensure that the weaknesses identified are taken into account for the implementation of phase III (see detailed Recommendations 4(a) to (f) to the Commission and the Member States following paragraph 94).

5. During phase III, the level of guidance and information about the implementation of the EU ETS should be improved (see detailed Recommendations 5(a) to (c) to the Commission and the Member States following paragraph 96).

6. The implementation of sanctions in relation to the EU ETS should be made more transparent. Up-to-date and accurate information should be available at Member State and EU level on the implementation and results of penalty procedures, and the Commission should better monitor enforcement practices across the EU as well as the consistent application of national penalties (see detailed Recommendations 6(a) to (c) to the Commission and the Member States following paragraph 97).

European Union Emissions Trading System (EU ETS)

01
The EU ETS is an essential pillar of the European Union's policy to combat climate change (for further background information on the international framework for emissions trading see ***Part I of the Annex***). Its objective is to promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner. It is one of the main components of the EU's climate and energy package[21], which has three objectives for 2020 (known as the '20-20-20' targets):

— 20 % reduction in EU greenhouse gas emissions from 1990 levels;

— raising the share of EU energy consumption produced from renewable resources to 20 %;

— 20 % improvement in the EU's energy efficiency.

02
The EU ETS is the world's largest cap-and-trade (see ***Box 1***) system for GHG emissions and is often quoted as the reference model for emerging climate change policy and emissions trading schemes elsewhere in the world. The cap restricts emissions of more than 11 000 energy-intensive installations across the EU[22]. From 2013, the EU ETS covers around 50 % of the greenhouse gas (GHG) emissions in the EU[23]. As well as limiting total emissions with a sufficiently high carbon price, the EU ETS should encourage installations to apply the most cost effective emission reduction measures, and promote investment in low-carbon technologies[24].

21 COM(2008) 30 final of 23.1.2008, '20 20 by 2020 Europe's climate change opportunity'.

22 Covering the following main sectors: combustion installations, cement, clinker, lime, mineral oil refineries, pig iron, and steel. Sectors which are not included include terrestrial transport, agriculture and the service sector.

23 COM(2012) 652 final of 14.11.2012, 'The state of the European carbon market in 2012'.

24 European Commission Climate Action, 'The EU Emissions Trading System (EU ETS)' factsheet, available at http://ec.europa.eu/clima/publications/docs/factsheet_ets_en.pdf

Box 1

The EU ETS cap and trade system

The cap-and-trade system works by putting a limit on overall emissions from high-emitting industry sectors. This limit is reduced over time. Within this limit, companies can buy and sell emission allowances as needed. Each allowance represents the right to emit 1 tonne of CO_2e. The amount of allowances determines the amount of emissions permitted, i.e. emissions are 'capped'. The allowances are distributed to installations, and can be freely traded on the market[25]. Each year, installations must surrender allowances equivalent to the amount of CO_2e emitted. The price is determined by the market.

25 COM(2010) 796 final of 21.12.2010, 'Towards an enhanced market oversight framework for the EU Emissions Trading Scheme'.

03
The EU ETS was established by Directive 2003/87/EC[26]. Under this directive, the Member States are required to develop and put in place the necessary systems and administrative arrangements to implement the EU ETS at national level. The directive also gives a range of specific responsibilities to the Commission, many of which are aimed at ensuring a consistent and coordinated implementation of the EU ETS. Since the EU ETS also created a market for the trading of emission allowances, the Member States and Commission need to ensure the integrity and stability of the EU ETS so that it can effectively contribute to its environmental objectives.

EU ETS in practice from 2005 to 2012 (Phases I and II)

04
The operation of the EU ETS is organised in trading periods or phases: for the first two phases (2005–12), the cap on allowances was set at national level through National Allocation Plans (NAPs) established by the Member States and assessed by the Commission.

05
The first phase (2005–07) of the EU ETS was a 3-year pilot period to prepare for the second phase (2008–12). Allowances were distributed free of charge. As most of the Member States did not yet have historical data on installation emissions included in the EU ETS, the phase I caps were based on studies and forecasts. The objective of the first phase was to establish a functioning market, to set a price for carbon and to build the necessary infrastructure for monitoring, reporting and verifying actual emissions. The data generated from the first phase then filled the information gap and helped set national caps for the second phase.

06
The second phase (2008–12)[27] coincided with the first commitment phase of the Kyoto Protocol — the 5-year period during which EU Member States should reduce their emissions according to the targets set under the Kyoto Protocol[28]. On the basis of the verified emissions reported from phase I, the volume of emission allowances permitted in phase II was cut to 6,5 % below the 2005 (i.e. first EU ETS compliance year) level, thus ensuring that real emission reductions would take place (see ***Part II of the Annex*** for more information on supply and demand developments during phase II of the EU ETS).

26 Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC (OJ L 275, 25.10.2003, p. 32).

27 In phase II, EEA–EFTA (European Economic Area — European Free Trade Association) members Iceland, Liechtenstein and Norway joined the EU ETS.

28 The European Union committed itself to achieving an overall reduction of 8 % of GHG emissions in the 2008–12 period as compared with 1990 levels (which is higher than the target referred to for overall industrialised countries in the ***Box of the Annex***). This target is shared among the 15 Member States under a legally binding agreement, the Council Decision 2002/358/EC of 25 April 2002 concerning the approval, on behalf of the European Community, of the Kyoto Protocol to the United Nations Framework Convention on Climate Change and the joint fulfilment of commitments thereunder (OJ L 130, 15.5.2002, p. 1).

EU ETS from 2013 (Phase III)

07
For phase III (2013–20), the system of NAPs was replaced. The cap for emissions from installations covered under the EU ETS is now set at EU level. For those allowances still given for free, harmonised allocation rules apply which are based on ambitious EU-wide benchmarks of emissions performance. As in previous phases, installations which are not allocated any or an insufficient number of free allowances to cover their emissions need to buy additional allowances on the market, or reduce their emissions.

08
At the beginning of phase III, over 40 % of all allowances are auctioned. Auctioning is considered by the Commission and economic theory as the most transparent allocation method and puts into practice the principle that the polluter pays (***Part III of the Annex*** provides more background information on reform and future perspectives of the EU ETS).

Audit scope and approach

09

In determining the audit scope and approach the Court focused on the fundamental issues of the system's integrity and implementation. The audit did not examine the overall effectiveness of the EU ETS. The objective of the audit was to answer the question 'Is the European Union Emissions Trading Scheme managed adequately by the Commission and the Member States?' This was done by addressing the following sub-questions:

(a) **Is there an appropriate framework for protecting the integrity of the EU ETS?** In order to answer this question, the Court examined the appropriateness of market regulation and oversight rules that apply to emissions trading, the legal status and definition of allowances, and the Union Registry system for recording and disclosing EU ETS data. This part of the audit focused on a range of measures in these areas, developed and proposed by the Commission since 2011 including developments introduced up to 30 September 2014. The audit scope did not include an assessment of national measures to address the risk of VAT carousel fraud[29].

(b) **Is the EU ETS correctly implemented?** In order to answer this question, the Court examined the implementation of the EU ETS by the Member States and the Commission during phase II of the EU ETS. This part of the audit only concerned the implementation of the EU ETS for stationary installations[30].

10

The audit was carried out at both the Commission and Member State level. The work at Commission level examined how the Commission guided the implementation of the EU ETS by the Member States and whether it fulfilled its own obligations under the applicable legal framework. Evidence was obtained from seven Member States. These were selected based on volumes and types of emissions. Visits were made to relevant authorities in five Member States (Germany, France, Italy, Poland and the United Kingdom). Documentary evidence was obtained from two others (Greece and Spain). The audit at Member State level focused on the allocation (NAPs) and surrendering of allowances, on systems for monitoring, reporting and verification of emissions and on sanctions applied in case of non-compliance. It did not cover auctioning, as auctioning was still only implemented at a very small scale and in a limited number of Member States towards the end of phase II.

11

In addition, evidence was obtained through substantive testing of documentation available at national Competent Authorities relating to 150 installations selected from these seven Member States, and an analysis of installation and compliance data obtained from the public EU Transaction Log (EUTL — see ***Box 2***). The selected installations were not visited on-the-spot as the Court did not have access rights.

29 Please see ***Box 3*** for more details on VAT issues.

30 Aviation was only included in the EU ETS as of 2012.

The framework for protecting the integrity of the EU ETS

12
In order to ensure sufficient liquidity in the emissions allowances market created by the EU ETS, and to establish a well-functioning mechanism contributing to the achievement of the environmental objectives of the policy, the market ought to be safe and attractive[31] for non-compliance buyers[32], as well as operators (compliance buyers) who have an obligation under the EU ETS directive to participate in the scheme. It is therefore important to consider whether the integrity of the EU ETS is sufficiently protected to maintain stability and to ensure investors' confidence in the market. Such protection requires appropriate market regulation and oversight as well as cooperation between regulatory authorities. Furthermore, the legal status and definition of allowances ought to be clear enough in order to contribute to stability and confidence in the market for emission allowances.

13
The EU Registry (see ***Box 2***) is a key element in protecting the integrity of the EU ETS, as it records and tracks all 'physical transactions' of allowances and enables the disclosure of essential information to the market. In addition to the environmental value of the instrument, the financial stakes of the EU ETS are considerable. The value represented by all allowances and other compliance units held in the Union Registry is estimated at more than 10 billion euro, depending on the price of those units and the time of measurement. Furthermore, the integrity of the EU ETS ought to be sufficiently protected against the type of incidents that occurred between 2008 and 2011 (i.e. reported thefts of allowances, VAT fraud schemes, and cyber threats such as phishing). It is therefore also essential that effective procedures exist for controlling account openings and transactions occurring in the Union Registry.

Regulation and oversight of the emissions market were continuously improved by the Commission, but further progress is needed

14
The Commission has recognised[33] that enhancing market regulation and oversight and improving the security of the Registry were required to prevent recurrences of the security incidents (also see paragraphs 12 and 13, and ***Box 2***) that occurred in phase II. The Commission developed a comprehensive package of measures to address these risks (as discussed below in paragraphs 15 and 16).

31 See for example COM(2010) 796 final.

32 Non-compliance buyers (or non-compliance traders) are entities participating voluntarily in the emissions market (e.g. traders, investors, individuals, financial intermediaries, etc.) as opposed to compliance buyers (operators required to participate by the legislation).

33 http://ec.europa.eu/clima/policies/ets/oversight/faq_en.htm, Ensuring the integrity of the European carbon market, FAQ, April 2014: 'The rules [i.e. financial market rules] also aim to provide a safe and efficient trading environment to enhance confidence in the carbon market in the wake of a series of unfortunate fraudulent activities which the market has experienced a few years ago'. Also see COM(2010) 796 final, in particular chapter 1 — Introduction.

Box 2

The system of national registries and the Union Registry

During phase I and most of phase II, the Member States operated national registries with accounts in which emissions allowances and international credits could be held and transferred. In order to simplify the system and to allow the future linking of the EU ETS to other international emissions trading schemes, it was decided in 2009 by co-legislators to centralise the national registries in a Union Registry maintained and administered by the European Commission. In 2008–11, a number of security incidents occurred involving mainly VAT fraud and cyber-attacks. The migration of accounts and data took place in June 2012. Despite this centralisation of the registries system, Member States are still solely responsible for opening, managing and updating accounts in their national sections of the Union Registry. The Commission's central administrator is not involved in the performance of these activities. An EU Transaction Log (EUTL) system checks, records and authorises all transactions initiated in the Union Registry to ensure that any transfer of allowances is consistent with EU ETS rules[34]. A public version of the EUTL makes relevant EU ETS data accessible to the public. The operation of the Registry (and the previous system of national registries) is governed by Commission regulations[35].

34 http://ec.europa.eu/clima/policies/ets/registry/index_en.htm

35 This involves in particular Commission Regulations (EC) No 2216/2004 of 21 December 2004 for a standardised and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision No 280/2004/EC of the European Parliament and of the Council (OJ L 386, 29.12.2004, p. 1) and (EU) No 920/2010 of 7 October 2010 for a standardised and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision No 280/2004/EC of the European Parliament and of the Council (OJ L 270, 14.10.2010, p. 1), Commission Regulation (EU) No 1193/2011 establishing a Union Registry from 1 January 2013 and amending Commission Regulations (EC) No 2216/2004 and No 920/2010 for establishing a Union Registry for the period ending 31 December 2012) and Commission Regulation (EU) No 389/2013 establishing a Union Registry for phase III.

15

The need to improve regulation for the carbon market coincided with the process of revising the framework for financial markets regulation (MiFID/MAD)[36]. This presented an opportunity for the Commission to consider the regulation of the carbon market in the context of the overall regulation of the financial markets. According to the Impact Assessment[37] accompanying the MiFID review proposal presented in October 2011, the two main options considered by the Commission were to create a tailor-made regime for the carbon market, or to classify emission allowances as financial instruments and include them in the framework of MiFID/MAD regulation. The question of which regulatory approach would be best suited to the emissions market was beyond the scope of this audit. Emissions derivatives[38], which are estimated by the Commission to represent over 90 % of the carbon market, are financial instruments and were therefore already regulated under MiFID and MAD in phases I and II of the EU ETS (2005–12). The secondary trading of spot emissions allowances was not. The Commission proposed in 2011 that MiFID be extended and tailored to also cover the secondary trading of spot emissions allowances by expressly classifying allowances as financial instruments. This proposal was adopted in 2014[39] and also brings emission allowances within the scope of the MAD/MAR framework. These new rules will apply from January 2017[40].

16

Other important measures taken by the Commission to enhance the integrity and security of the EU ETS included:

— providing the Member States with the possibility to apply a reverse charge mechanism to address the value added tax (VAT) fraud (see ***Box 3***);

— additional security measures for the Union Registry to combat potential cyber-crimes and international credits recycling;

— the integration of anti-money-laundering provisions in the registry regulations, inspired by the anti-money laundering directive[41]; and

— establishing conduct and participation rules for the primary market in the auctioning regulation[42].

17

These measures represent a significant improvement to the regulation of the carbon market, and indeed there has been a marked reduction in reported incidents in recent years. Despite these efforts, the Court however identified a certain number of weaknesses concerning the introduction of the measures, and remaining issues which need to be considered in order to make the framework sufficiently robust. These are identified in the following sections.

36 MiFID and MAD are two key pillars of financial markets regulation. MiFID (markets in financial instruments directive) covers the provision of investment services in financial instruments, MAD (market abuse directive) covers market abuse.

37 Commission Staff Working Paper, Impact Assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council on Markets in financial instruments (Recast) and the proposal for a regulation of the European Parliament and of the Council on markets in financial instruments of 20 October 2011 (SEC(2011) 1226 final).

38 A derivative is a financial contract linked to the future value or status of the underlying asset to which it refers (e.g. the development of interest rates or of a currency value, or the possible bankruptcy of a debtor). (http://europa.eu/rapid/press-release_MEMO-12-232_en.htm?locale=en)

39 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).

40 From July 2016 for the market abuse regulation.

41 Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (OJ L 309, 25.11.2005, p. 15). In 2013 the Commission adopted proposals to update it and the European Parliament and the Council reached a political agreement at the end of 2014.

42 Commission Regulation (EU) No 1031/2010 of 12 November 2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowances trading within the Community (OJ L 302, 18.11.2010, p. 1).

Box 3

The ETS market remains at risk to VAT fraud

In its General Report on Activities for 2009, Europol estimated that the loss to carbon credit fraud (through VAT carousel fraud) between June 2008 and December 2009 was approximately 5 billion euro. The ETS market was particularly vulnerable to this type of cross-border trading criminal activity. In response to the fraud incidents, a directive (2010/23/EU)[43] was adopted to give Member States the possibility to implement a VAT reverse charge mechanism, putting the obligation to pay VAT onto the person to whom allowances or other compliance units are transferred. This provision has been prolonged until December 2018 (Directive 2013/43/EU)[44].

At the time of the audit, almost a third of the Member States had not implemented the reverse charge mechanism for emission allowances. The risk of value added tax (VAT) fraud on EU ETS allowances is consequently still not fully addressed in the European Union.

Out of the five Member States visited by the Court, only Italy had not yet applied the VAT reverse charge mechanism at the time of the audit. The only trading platform for emission allowances in Italy suspended its operations of the emission allowances market in December 2010 due to observed anomalies in fluctuations of trading. Operations of the exchange were permanently shut down in March 2014. Bilateral trading of allowances involving Italian accounts in the EU ETS Registry is of course still possible. The Competent Authority and the National Registry Administrator considered, at the time of the audit, that there was a material risk of VAT carousel fraud occurring in Italy due to the absence of the VAT reverse charge mechanism.

43 Council Directive 2010/23/EU of 16 March 2010 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain services susceptible to fraud (OJ L 72, 20.3.2010, p. 1).

44 Council Directive 2013/43/EU of 22 July 2013 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible to fraud (OJ L 201, 26.7.2013, p. 4).

Despite the qualification of emission allowances as financial instruments, the audit identified certain remaining issues related to regulation and oversight of the emissions market

18

The Court examined how the Commission's 2011 MiFID review proposal addressed the specificities of emissions trading. One of these specificities is the presence of compliance traders in the EU ETS emissions market (trading both spot allowances and derivatives). This market is now to a large extent a financial market, but is characterised by the participation of compliance traders and therefore requires careful consideration when regulations are revised. The Commission's review proposal included exempting EU ETS compliance traders from the requirement to obtain a MiFID authorisation[45]. The Court identified certain aspects in relation to the application of MiFID to the emissions market, which raise issues relating to its regulation and oversight and which have not been sufficiently analysed. These are set out in the following paragraphs.

19

Compliance traders as well as certain other entities trading emissions allowances[46] will be exempt from obtaining a MiFID authorisation under the revised MiFID framework. In particular, large compliance traders which often have substantial specialised trading desks, will be exempt if they trade on their own account[47] for the EU ETS. Small entities trading spot emission allowances voluntarily on own account may also operate without MiFID authorisation[48]. The Court considers that there is a risk to the market's integrity if such entities abuse the exemption introduced by MiFID by engaging in trading activities not covered by their exemption. Furthermore, the Court identified a risk that the MiFID exemption of compliance trading entities might be abused by parties trying to acquire installations for the purpose of buying and selling spot emission allowances without a MiFID licence. The Court found that the Commission had not sufficiently analysed the impact of compliance traders on the emissions market to demonstrate that any resulting risk of exempting groups of market participants was not significant.

45 In order to provide investment services the investment firm needs to obtain an authorisation from the national regulator.

46 E.g. Article 2(1)(j)(i) of Directive 2014/65/EU relating to persons dealing on own account in emissions allowances or derivatives thereof.

47 And comply with the requirements set out in Article 2(1)(e) of Directive 2014/65/EU.

48 A 2012 expert's report contracted by the Commission on the parts of the MiFID Impact Assessment relevant to the emissions market also referred to the potential implications of likely MiFID exemptions for smaller market actors, which may also have been involved in fraud and alleged theft of allowances, and who will not require MiFID authorisation, even if carbon allowances were classified as financial instruments.

20

Furthermore, purely bilateral OTC trades, including trading of emission allowances, executed outside MiFID-regulated venues will remain outside the ambit of the revised MiFID. The 'physical' delivery of emission allowances traded bilaterally between two parties requires both parties to hold an account in the EU ETS Union Registry. However, as discussed below in paragraphs 37 and 38, these 'physical' transactions in the Union Registry are not subject to supervision. This means that there may be actors operating in parts of the market with limited visibility for regulators and competent authorities. The classification of emission allowances as financial instruments under MiFID will therefore not bridge this regulatory gap. However, unregulated bilateral spot trading, relative to derivatives trading, according to the Commission represents a small proportion (around 1 %) of the secondary emissions market.

21

The Commission also proposed[49] an exemption, subject to a threshold, for smaller market participants from the duty to disclose inside information under revised market abuse rules (MAD/MAR). The audit did not find evidence that the Commission sufficiently analysed the identity and behaviour of such participants and the information held by them, as well as their potential cumulative effect on the emissions market. The significance of this issue depends on how 'smaller' participants are defined, which had not yet been established at the time of the audit.

There are concerns regarding some elements of the suitability of the supervisory framework for the emissions allowances market

22

As with any market mechanism, appropriate market oversight is required to protect the integrity of the EU ETS (see also paragraph 12). This should involve the Commission consulting with national financial regulators as regards the functioning of the emissions market, and considering the issue of regulatory cooperation in the emissions market. It is also important that a system of ongoing and effective cooperation concerning the functioning of the carbon market be established within the European Commission, principally between the services responsible for EU ETS and financial markets regulation, namely DG Climate Action[50] and DG Internal Market, Industry, Entrepreneurship and SMEs'[51].

49 Commission Staff Working Paper, Impact Assessment accompanying the document Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) and the proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation of 20.10.2011, SEC(2011) 1217 final.

50 Directorate-General of the Commission responsible for Climate Action.

51 Directorate-General of the Commission responsible for the internal market and services. As of 2015, DG Internal Market and Services is called DG Financial Stability, Financial Services and Capital Markets Union.

23
Despite its cross-border nature and concerns expressed about fraud and other criminal activities (also see paragraphs 13, 14 and ***Box 2***), the Court found that no EU level oversight of the emissions market has been established. National financial regulators can request their national administrators or the central administrator to provide information from the Union Registry on transactions in emissions allowances under restricted procedures defined in the registry regulation. However, the Court found that at the time of the audit, such practices were rarely used at the level of the Member States. Furthermore, the Union Registry does not register price or financial information related to transactions. As a consequence, national regulators cannot obtain a full picture in relation to any cross-border transaction they view as suspicious and have less information available in relation to transactions that might be suspicious. The Commission has no supervisory powers in this area (see also paragraphs 37 and 38). This increases the importance of cooperation between national regulators to ensure that the trading of emissions allowances is subject to an adequate level of supervision, and that the potential for abuse is kept to a minimum.

24
The Court considers that there are no integrated procedures between national regulators for organising an EU-level supervision specifically for the emissions market, and that concerns remain over the framework for supervision of the emissions market that will be in place once the revised MiFID and MAR take effect[52]. Within the Commission itself cooperation between DG Climate Action and DG Internal Market and Services is organised in an informal and ad hoc manner, which does not sufficiently facilitate a coordinated approach to monitor the emissions market. The existing formal procedures for inter-service consultation and making legislative proposals are not designed for coordinating the regulation and monitoring of the emissions market.

Concerns related to the definition of allowances

25
In order to function well, the emissions market needs sufficient liquidity (see also paragraph 12). In this respect, the operation of the emissions market could improve if there were more certainty over the EU-wide definition of allowances and if emission allowances were more commercially interesting for voluntary participants, for example by supporting the ability to create and protect secure and enforceable security interests[53].

52 An expert's report contracted by the Commission also identifies potential remaining gaps in the framework for supervision of the emissions allowances even after the adoption of the revised financial market regulations. Many different actors will share a part of the supervisory responsibility for the carbon market. This raises concerns over remaining gaps, potentially requiring further adjustments of the regulations, should market operation be disrupted.

53 Security interests are third party legal rights such as mortgages or other legal charges.

26

The EU ETS directive did not define the legal status of allowances. The description of allowances as fungible, dematerialised, tradable instruments in the EU registry regulation[54] only explains some of the ways in which allowances can be used. Moreover, designating allowances as financial instruments only clarifies how they should be treated under financial services legislation. It remains unclear what rights the holders of emissions allowances have. The audited Member States have different approaches to the legal status and nature of allowances. In France and the United Kingdom, the characteristics of allowances are compatible with the legal attributes of property or are treated as such. However, in most of the Member States audited, there is no legal definition of emissions allowances.

27

The lack of legal certainty at EU and Member State level and the different approaches taken means that legal problems arising are dealt with on a case-by-case basis. This further increases the risk for divergent legal definition and treatment, not just between Member States (most of which are yet to define allowances in their national legal systems), but within a single Member State's national law as well. This issue of the absence of an EU-wide legal definition of allowances was already raised in several experts' reports[55] contracted by the Commission. However, the Commission has not taken any action to address the issue. The Court considers that greater clarity regarding the legal definition of allowances has the potential to be beneficial to the functioning of the market.

28

Moreover, it is currently not clear, from a legal and a practical point of view, whether emissions allowances can be used to support security interests, as is the case with traditional financial instruments of commercial value. There is no express provision for the registration of security interests in allowances. Under the EU registry regulation, the practical solution to register interests in allowances is by nominating 'additional authorised representatives'[56], whose permission would be needed to perform transactions involving these allowances. An express EU-level provision that emissions allowances are capable of supporting the existence of security interests, and a registration mechanism for such interests, may increase the commercial value of emissions allowances for market participants.

54 Article 40(1) of Commission Regulation (EU) 389/2013.

55 The Court obtained two experts' reports contracted by the European Commission; one on the parts of the MiFID Impact Assessment relevant to the emissions market (2012) and one on the interplay between the EU ETS Registry and post trade infrastructure (2013), which both identify similar risks to those identified by the Court.

56 Article 21(3) of Commission Regulation (EU) 1193/2011, and Article 23(3) of Commission Regulation (EU) 389/2013.

The systems related to the EU Registry for processing fundamental EU ETS information showed certain shortcomings

29
The Union Registry is the electronic system for recording allowances and their ownership and processing fundamental EU ETS data for installations and trading entities (see also paragraph 13 and ***Box 2*** above). Rules for account opening procedures are included in the registry regulation[57] and implemented by the national administrators. The account opening procedures for voluntary participants (e.g. for trading or investment purposes) are particularly important, as they define the conditions under which entities other than compliance traders can set up an account to trade allowances. In addition, once traders have access to an account, they can initiate cross-border transactions.

30
The Union Registry has a high risk profile and its operation should therefore involve identification and targeted tracking of transactions, as well as controls and identification of account holders and balances. In order to support market integrity, rigorous account opening procedures should be implemented in a consistent way by all Member States, and cross-border monitoring of potentially suspicious transactions should take place to deter and detect fraudulent or criminal activities. Anti-money laundering and anti-terrorist financing provisions have been included in the registry regulation and specify how national administrators should cooperate with relevant competent authorities in these domains, notably the financial intelligence units and law enforcement bodies. Given the high financial stakes and security risks, the successful operation of the Registry requires sound governance structures, with appropriate segregation of IT and business duties in the internal organisation of the Commission and sufficient resources.

31
The development of the security architecture of the Union Registry also took into account past incidents (see paragraph 13). The Court found that while the registry systems and processes improved over time, certain shortcomings remain as described in the following sections.

57 Commission Regulation (EU) No 920/2010.

Procedures for the opening of accounts were not sufficiently robust

32

Following a series of serious incidents affecting the security of the Registries' system between 2008 and 2011 (see paragraph 13 and ***Box 2***), the security of the EU ETS was further enhanced in 2011. The rules for account opening and acceptance of authorised representatives (i.e. so-called KYC[58] checks) were significantly expanded. The registry regulation establishes rules for opening person holding accounts in the Union Registry and gives the grounds on which national administrators may refuse to open an account for voluntary participants, notably if the person requesting the account opening is under investigation for being involved in fraud involving allowances or Kyoto units, money laundering, terrorist financing or other serious crimes to which the account may be an instrument. Furthermore, Member States were given the possibility to define more detailed national rules for refusing to open accounts in the Registry. There is also a requirement to share information between Member States on refusals to open accounts.

33

Although the centralisation of the Registry System was introduced in June 2012 when the national registries were migrated to the new Union Registry managed by the Commission, the account management (and access of individuals and legal entities to emissions trading accounts) is still the sole responsibility of the Member States and their national administrators. Similar to the situation before centralisation of the national registries, the national administrators cannot access data from other Member States' sections of the Registry.

34

The Court identified many differences in processes, internal organisation and administrative capacity regarding the KYC-checks and risk profiling practices between Member States, with France and the UK as examples of Member States going beyond the minimum requirements in this area. These Member States demonstrated extensive procedures for risk assessments and detailed background checking.

35

However, despite the strengthening of the framework for opening of accounts since 2011, the Court found that the following weaknesses persisted in most of the Member States visited:

— requests for account openings were not being refused[59], even when this would have been justified based on the criteria provided in the registry regulation for refusing to open an account (see paragraph 32);

— information on suspicious applications for account openings was not shared between national administrators and the Commission in an effective way (e.g. due to the lack of a legal basis there is no permanent EU-wide list of refused account openings, this information is only shared temporarily, and applications which were not formally refused but still interrupted because of suspicions of the national administrator, were not shared with other Member States as refused account openings);

58 Know your customer (KYC) is the process used by financial institutions or other entities to conduct customer due diligence, (i.e. to carry out checks on customers in order to verify their identity, the identity of the beneficial owner, to understand the nature of the business relationship and to ensure that it is monitored on an ongoing basis). This is required in order to conform to due diligence and financial regulatory legislation, such as anti-money laundering (AML) and countering the financing of terrorism (CFT) (http://ec.europa.eu/internal_market/company/docs/financial-crime/130205_impact-assessment_en.pdf).

59 During the audit the Court was informed of only three such cases from Germany (1) and France (2), two of which applied to phase III.

— most of the visited Member States did not use the option to develop national rules for account opening;

— internal procedures for account openings to verify that all required elements of the applications from prospective account holders had been collected were in many cases not duly documented or subject to a four-eye-principle (e.g. Germany, Italy, Poland); and

— formal relations of Competent Authorities and national administrators with national financial intelligence units or law enforcement bodies were still under development and not operational at the time of the audit (notably Italy and Poland).

36

Account opening procedures drive the access to the system by assessing the integrity of market participants. Countries which are less stringent in their checks for account openings may be targeted by individuals with criminal intentions. However, as regards these procedures, the registry regulation does not provide the Commission (in its role as central administrator) with the authority to enforce a coordinated implementation of the Member State systems.

Transactions are insufficiently supervised and monitored at EU level

37

Previous criminal events (see paragraph 13 and ***Box 2***) in the EU ETS have caused serious financial damage for Member States and some individual participants and posed a significant risk to the reputation of the EU ETS and the European Commission. This is also reflected in the reservation repeated by DG Climate Action in its 2012 and 2013 Annual Activity Reports produced since the centralisation of the Registry in 2012 (also see paragraph 41). Even if the Commission operates the EU Registry at central level, it has no legal basis to supervise and monitor transactions. There is no EU-level monitoring for potentially suspicious transactions in the Union Registry (see also paragraph 23). This situation could undermine the integrity of the EU ETS.

38
Member States' registry administrators have to inform the national authorities in charge of anti-money laundering (Financial Intelligence Units) about suspicions of money laundering or criminal activity. The Court considers that in order to do this effectively, appropriate procedures should be developed to monitor potentially suspicious transactions. Since the centralisation of the Union Registry at the level of the Commission in 2012, Member States no longer have direct access to their national registry databases. Member States have difficulties in analysing cross-border transaction data. Some Member States[60] cooperate on an ad hoc basis and develop common tools outside the Registry system. Although the Commission manages the centralised database, it cannot fully exploit the data it has at its disposal because of data protection and confidentiality issues. The Court considers that in this situation, in which Member States and the Commission face technical limitations and data protection restrictions, the risks of abuse that have already materialised cannot be fully addressed.

Internal coordination issues and resource constraints hampered the management and development of the Union Registry

39
As referred to in paragraph 30, the effective implementation of the Registry requires a careful assessment of objectives and priorities and an adequate allocation of resources. In addition, adequate arrangements should be in place for the segregation of duties between IT and business duties within the responsible Commission service.

40
During phase II of the EU ETS, the Court noted that the Commission has been actively involved in many important activities (see paragraph 16) aimed at increasing the maturity and credibility of the EU ETS.

41
However, the Court considers that the organisational structure and available resources in the Commission services did not sufficiently facilitate the management and development of the Registry. The Court found that IT and business responsibilities were not adequately defined and segregated in the services of DG Climate Action responsible for the implementation of EU ETS. The descriptions of the functions in DG Climate Action's Registry team were generic and show overlaps. The Commission's Internal Audit Service already issued audit recommendations in this domain[61]. Although an action plan for these recommendations was being implemented at the time of the audit, further progress is required, to increase the effectiveness of the Registry management and development. In this context the Court also draws attention to the reservations raised by DG Climate Action in its Annual Activity Reports for 2012 and 2013 regarding security threats to the Union Registry[62].

60 According to the Commission, approximately 10 Member States at the time of the audit.

61 The Court's findings are supported by an internal Commission report. For further information, see DG Climate Action Annual Activity Report 2013, Chapter 2.3 Assessments of audit results and follow-up of audit recommendations.

62 DG Climate Action Annual Activity Report (AAR) 2013, Executive summary: 'The Reservation on reputational grounds related to remaining significant security weakness identified in the Union Registry for the Emissions Trading System (EU ETS) issued in the AAR 2010, 2011 and 2012 is repeated in the AAR 2013. No reasonable assurance can be provided that the current security measures could successfully prevent a future attack. This security assurance is conditional to lifting the reservation'.

The implementation of the EU ETS

42

The implementation of the EU ETS started in 2005, but the first actual commitment period under the Kyoto Protocol ran from 2008 to 2012 (EU ETS phase II). The implementation of the EU ETS by Member States should involve the allocation of allowances to installations, the implementation of the NAPs and relevant rules by the Member States, emissions monitoring, reporting and verification procedures, including the accreditation or recognition of verifiers where applicable.

43

The EU ETS annual compliance cycle in the Member States during phase II is described in ***Box 4***. In this framework, the approval of monitoring plans is a key control as the correctness of the data and parameters included in these plans is of significant importance for reliable emissions reporting. The EU ETS directive and the Monitoring and Reporting Guidelines (MRG) issued by the Commission for phase II[63] described the content of emission permits, monitoring plans, emissions reports, and to a certain extent, verification reports, as well as the deadlines by which they should be provided. They did not define which controls should be applied to them by the Competent Authorities. For phase III, the control framework was revised, and additional responsibilities for verification, and for accreditation of verifiers, were introduced[64].

44

The directive defined the European Commission's role which includes the assessment of NAPs, giving guidance to the Member States, coordinating an exchange of information between Competent Authorities and monitoring, to a certain extent, Member States' implementation.

45

In order to enforce the correct surrendering of allowances, appropriate sanction regimes should be in place which are effective, proportionate and dissuasive. The directive provided for a '100 euro' penalty per ton of CO_2e in cases where an operator did not surrender sufficient allowances to cover its emissions during the year[65]. Member States were also required to establish national penalty provisions for other types of infringements of the EU ETS rules.

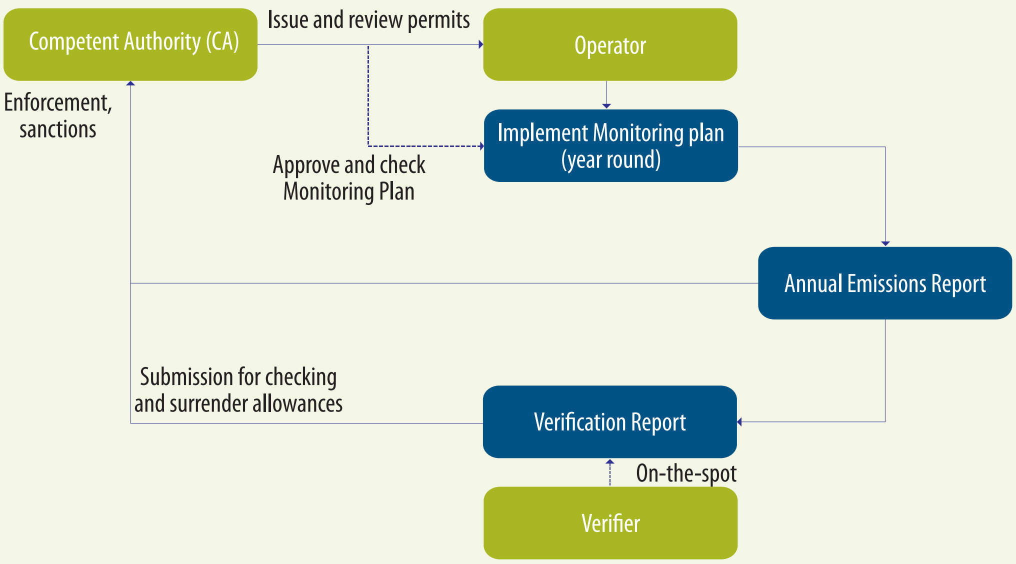
63 On 18 July 2007, the Commission adopted Decision 2007/589/EC establishing guidelines for the monitoring and reporting of greenhouse gas emissions pursuant to the EU ETS directive, which applied and were updated during phase II (2008–12) (OJ L 229, 31.8.2007, p. 1).

64 Commission Regulation (EU) No 600/2012 of 21 June 2012 on the verification of greenhouse gas emission reports and tonne-kilometre reports and the accreditation of verifiers pursuant to Directive 2003/87/EC of the European Parliament and of the Council (OJ L 181, 12.7.2012, p. 1).

65 Article 16 of the Directive 2003/87/EC.

Box 4

Global overview of the EU ETS Phase II compliance cycle



Competent Authority: Member States assign one or more (i.e. regional) Competent Authorities responsible for the implementation of the EU ETS directive.

Permit and monitoring plan: in conformity with the ETS directive and the monitoring and reporting guidelines issued by the Commission, the Competent Authority adopts GHG emissions permits for the operators' installations which include a monitoring plan describing the technical details of the installation and how emissions will be monitored (i.e. by applying calculations and/or measurements) and reported.

Annual emissions report and verification report: based on the monitoring performed during the year, operators prepare an annual emissions report which is verified by an independent verifier contracted by them. The verifier checks the annual emissions report and issues a verification report inclusive of a verification opinion. These documents are sent to the Competent Authority before 31 March of the following year. The verifier also establishes a more detailed internal verification report which may be sent to the operator and/or the Competent Authority.

Surrendering of allowances: based on the figures in the verified annual emissions reports, the correct number of allowances is surrendered from the operator's account in the Registry before 30 April of the following year.

Source: ECA's analysis based on legislative framework and guidance on monitoring and reporting.

Member States' systems for the recording and reporting of emissions during phase II of the EU ETS were not sufficiently developed

46
The Member State systems for recording and reporting emissions comprised:

- procedures to ensure that emissions of installations were correctly monitored;
- procedures to ensure that emission reports of installations were correctly verified;
- procedures to ensure the quality of work performed by verifiers;
- inspections by competent authorities of installations;
- reporting on the implementation of the EU ETS.

47
As the EU ETS was established by means of a directive under the Environment heading of the Treaty, this policy area remains primarily the competence of the Member States. Consequently, they can implement the scheme in different ways, which is illustrated in ***Box 5***.

Box 5

Diversity of implementation models in the Member States

In Greece, the EU ETS is implemented centrally. The Competent Authority for the EU ETS is the Emissions Trading office of the Directorate-General of Environment, within the Ministry of Environment, Energy and Climate Change. It is responsible for most elements of the annual compliance cycle and issues the emissions permits, approves the monitoring plans, collects the verified annual emissions reports and communicates to the national registry administrator the verified emissions figures. It is also responsible for setting penalties and sanctions.

Italy also applies a centralised approach. A Committee is responsible for the implementation of the EU ETS, supported by a Technical Secretariat at the Environment Ministry in Rome. During phase II, the Committee was responsible for approving EU ETS permits, monitoring plans, for the reporting cycle, and for recognising verifiers.

Spain operates a largely decentralised implementation of EU ETS, in which the relevant authorities of the autonomous communities approve permits and monitoring plans, and also monitor the reporting cycle. The central Competent Authority under the Environment Ministry is responsible for the overall coordination of the implementation of the EU ETS in Spain and facilitates harmonisation by issuing guidelines and organising a dedicated coordination committee.

In Germany, in France and in Poland regional and/or local authorities were usually involved in issuing emissions permits and approving and checking monitoring plans, whereas the national Competent Authority generally played a leading role in the emissions reporting chain and coordinating the overall implementation of the EU ETS.

There were weaknesses and delays in procedures for approving monitoring plans

48
The approval of installations' monitoring plans is of key importance for issuing emission permits to installations, and to enable the future reliable reporting of emissions.

49
The Court found that procedures to approve monitoring plans were weak in most of the Member States audited, as illustrated in ***Box 6***.

Box 6

Weaknesses in procedures to approve monitoring plans

In France, there is no harmonised methodology at national level to analyse, control and approve the monitoring plans. Even within the same region approaches can vary depending on the controller (environmental inspector). In Poland, the audit found that the checks performed by the local authorities on the monitoring plans are limited to the desk-review of basic elements of the plans. No other more detailed checks are carried out on the installations to verify the reliability of the submitted data and ensure that the monitoring plans precisely reflect the situation of the installation.

In Germany, the Court found that during phase II of the EU ETS, there were differences between the *Bundesländer* in the way the rules for defining an installation were applied. In practice a certain installation site in one *Bundesland* could receive one single permit for the whole site including all of its facilities, whereas in other *Bundesländer* the site could be split up in several installations with separate permits. The size of an installation, defined in the permit, may have had an impact on whether the installation passed the threshold for participation in the EU ETS or not. Furthermore, during the first half of phase II, *Bundesländer* took different approaches to the approval of monitoring plans (or 'concepts' as they were called in Germany), with some of them approving the entire monitoring plan from the beginning of phase II and others only approving deviations from the monitoring guidelines. A Court ruling[66] later ordered harmonisation of approval practices acknowledging that the approval of a comprehensive monitoring plan by the relevant authorities for the whole of phase II was important because it reduced the risk of erroneous emissions reporting.

In Spain, Italy and Greece, there were delays of up to 2 years in the creation and approval of monitoring plans for phase II, following the adoption of the phase II MRG in July 2007. According to the Competent Authorities, timeframes were too short to transpose the new rules into national guidelines or regulations and incorporate the new monitoring plan in the emissions permit before the start of the reporting period. In some cases, monitoring plans were not formally approved until 2010.

66 Bundesverwaltungsgericht 7 C 10.09 of 18.2.2010.

The reporting of findings by verifiers lacked clarity and follow-up by Competent Authorities was limited

50
The EU ETS directive gives Member States the general responsibility to ensure that emissions are monitored at installation level and verified in accordance with the rules set out in the EU ETS directive and the guidelines provided by the Commission[67]. The main steps related to monitoring, reporting and verification in the annual compliance cycle of the EU ETS are shown in ***Box 4*** above and were based, in phase II, on these guidelines and principles. In this context, checks of verified annual emissions reports received from operators are a central element of the control framework at the level of the Competent Authority. Based on its examination of the documentation related to 150 installations across seven selected Member States, the Court identified many differences in the approaches to the organisation of such checks and in their level of effectiveness.

51
During phase II of the EU ETS, there was no standard template defining the mandatory content of a verification report. In the absence of such a template or more specific guidance on the nature and content of such a report, many different formats and approaches were developed, which did not always enable a clear overview of verification findings and conclusions.

52
The Court found that the evidence available at the Competent Authority on the correct performance of the verification was sometimes insufficient or unclear[68]. For example, there were limited descriptions of certain verification findings, and a lack of follow-up on previous year's findings or results from remedial actions. In most of the selected Member States, evidence could not be obtained of actions by the Competent Authorities prompted by repeated reporting of findings. Such repeated findings were for example related to not applying the required detail in the emissions calculations, not calibrating measurement or weighing devices at the required intervals or not using a laboratory with the correct accreditation. The Court found cases in most Member States where verifiers' findings were repeated from year to year, without adequate information on the reasons, background or follow-up. However, the Court also identified many cases in most Member States where verifiers reported no findings at all, despite the complexity and size of individual installations or the relatively low level of experience with emissions monitoring and reporting under the EU ETS. ***Box 7*** provides further detail on these findings.

67 Decision 2007/589/EC.

68 The Court also found that none of the selected Member States used the possibility — provided by the guidelines — for Competent Authorities to evaluate the work of the verifiers by requesting and reviewing their internal verification reports. This is further explained in paragraphs 53 to 57.

Box 7

Examples of lack of consistency in the reporting of verification findings

Germany applies a highly automated and standardised electronic system for submitting verified annual emissions reports. This provided a clear view of the results of the verification work and the actual opinion of the verifier on the emissions figures, but did not provide detailed information on the methodology used and work performed by the verifiers. Moreover, the forms did not have specific text fields in the verifiers' section requiring the verifiers to list recommendations for improvements or to provide specific follow-up on findings and comments from previous year.

In France, the Competent Authority received a declaration of reasonable assurance on the annual emissions report from verifiers. In these declarations, the verifiers note their comments and issues of non-conformity. However, the audit found that some verifiers never reported any issues in their declarations even if the internal verification reports contained findings, and that the content of the declaration of assurance varied between verifiers.

The Italian national legislation foresees the use of specific reporting templates by verifiers. A high level of standardisation is therefore achieved in the reporting chain. However, the Court noted that in the majority of cases verifiers reported no findings. This contrasted with the example of the UK, where in the majority of cases verifiers reported findings.

In one case in Italy, a verifier reported many findings for the first 3 years. The documentation did not show how and whether all issues were resolved or whether the Competent Authority had intervened. However, for reporting year 2011 the operator contracted a new verifier which did not report any findings for that year.

In Poland, the Competent Authority uses an electronic database to cross-check reported emissions, but does not follow up findings, if any, reported in verifiers' opinion statements.

The quality of the work performed by verifiers was not sufficiently controlled

53

The EU ETS directive and the associated guidelines for monitoring and reporting in phase II did not introduce clear-cut requirements for accreditation of independent verifiers or for quality control on the work performed by verifiers. The directive specified the minimum competency requirements for verifiers, and the MRG included definitions of 'verifier' and 'accreditation' and requested Member States to consider respective guidance issued by the European Cooperation for Accreditation (EA)[69]. The MRG also provided the possibility for Competent Authorities and accreditation bodies to evaluate the verifiers' internal verification report[70]. Member States had significant discretion in these areas, which was not conducive to the effective implementation of the guidelines. Operators did not therefore face the same requirements throughout the EU, and assurance obtained from verification activities was reduced.

54

All Member States selected for the audit operated some form of accreditation or recognition of verifiers for the purpose of creating pools of approved verifiers that could be contracted by the operators. In Italy, the recognition of verifiers was performed by the national Competent Authority. It established a list of 23 recognised verifiers for the EU ETS in Italy, but did not perform periodic quality assessments or surveillance on their work. This model is discontinued in phase III. In other Member States audited, the accreditation or recognition was issued by an existing accreditation or recognition body.

55

The Court found that Competent Authorities in the selected Member States relied heavily on the work performed by verifiers to obtain assurance regarding the annual emissions reports. However, none of the Member States' Competent Authorities performed specific controls of the quality and substance of the verification reports and associated documents, as they considered this to be the responsibility of the accreditation bodies. Similarly, none of the selected Member States used the possibility provided by the guidelines to request verifiers' internal verification reports[71] and use these to evaluate their work.

56

Moreover, in three (Germany, Poland, United Kingdom) out of five Member States visited, where verifiers were accredited by an independent body, there was a lack of coordination or regular exchanges of information between the Competent Authorities and the accreditation bodies concerning the completeness and quality of verification reports and the assurance that could be derived from those.
The Court notes that only Competent Authorities had direct and full access to verified annual emissions reports submitted to them. The Court considers that the findings presented above were in part due to the lack of provisions on accreditation and (quality) control activities in the EU ETS framework and the absence of an obligation for Competent Authorities to engage in reviews of the work done by verifiers during phase II of the EU ETS.

69 The European cooperation for Accreditation or EA is an association of national accreditation bodies in Europe that are officially recognised by their national governments to assess and verify — against international standards — organisations that carry out evaluation services such as certification, verification, inspection, testing and calibration (also known as conformity assessment services) (http://www.european-accreditation.org/about-us).

70 Commission Decision 2007/589/EC, section 10.4.2(d), see also ***Box 4***.

71 See ***Box 4*** for more background information.

57
In addition there was no rotation policy in force in any of the Member States to strengthen the independence and impartiality of verifiers. In France and Poland, the Court identified cases in which verifiers were not only involved in verification of the emissions reports, but also in developing the monitoring plan for the same installation or other related activities (such as inspections of installations for the Competent Authority) which could lead to a conflict of interest.

On-the-spot inspections of installations were very limited

58
The EU ETS directive and the MRG do not define which controls should be performed on the installations by the Competent Authorities. In particular, there was no requirement for on-the-spot inspections of installations by Competent Authorities in order to assess the implementation of the monitoring plan or the reliability of verified emission reports.

59
With the exception of the United Kingdom, the Court found in the Member States visited that Competent Authorities did not perform on-the-spot visits in the context of the EU ETS. Other types of visits to installations were often performed by government bodies, for example in the context of IPPC[72] permitting or waste and environmental legislation, which were considered to be of higher priority (e.g. Germany, France and Poland) but did not specifically address EU ETS issues. In Germany and in Spain, the Court identified some cases of regional Competent Authorities accompanying verifiers on-the-spot on an ad hoc basis.

60
No centralised statistics of EU ETS inspections could be obtained in any of the selected Member States, except in the UK, where the number of visits gradually decreased[73] towards the end of phase II.

There were shortcomings in the reporting on the implementation of the EU ETS by the Member States

61
The Member States have an annual reporting obligation under Article 21 of the EU ETS directive. Their annual reports on important aspects of the application of the directive should be submitted to the Commission. In addition to this mandatory annual reporting, the Court considers that Member States should inform the public at large of the national implementation of the EU ETS and its results.

62
The Court found that Italy did not produce and submit to the Commission the required Article 21 reports for 2010, 2011 and 2012 and that France only produced the report for 2012 after the Court requested it.

72 Integrated Pollution Prevention and Control (until 2013), based on Directive 2008/1/EC of the European Parliament and of the Council of 15 January 2008 concerning integrated pollution prevention and control (OJ L 24, 29.1.2008, p. 8), replaced by Directive 2010/75/EU of the European Parliament and of the Council of 24 November 2010 on industrial emissions (OJ L 334, 17.12.2010, p. 17).

73 In the UK, the percentage inspection rate of installations reduced from approximately 5 % at the start of phase II in 2008, to approximately 1 % at the end of phase II in 2012.

63
As regards other types of reporting to inform the public of the national implementation of the EU ETS, Germany and Spain produced extensive annual reports on the EU ETS, including trend and sector analyses of emissions and compliance figures. However, Greece, France and Italy provided little specific public reporting on the national implementation and results of the EU ETS. The United Kingdom produced an annual national report on the EU ETS only until 2010.

There were gaps in the Commission's guidance and monitoring of Member States' implementation during phase II of the EU ETS

64
For phase II, the Commission's responsibilities[74] included an assessment of the Member State allocation rules laid down in the NAPs, giving guidance to the Member States and monitoring the implementation of the policy. These tasks for the Commission are mainly intended to ensure that the EU ETS correctly functions as a Europe-wide system, distortion of competition is avoided, and other issues of non-harmonisation do not negatively impact the effective functioning of the EU ETS as a market-based tool to achieve emission reductions in the most cost-effective way. Stakeholder confidence in the proper functioning of the EU ETS would be supported by regularly disclosing detailed and relevant information on the overall implementation and functioning of the system, especially when it is implemented in a decentralised way.

The Commission's assessment of phase II NAPs lacked transparency

65
For phases I and II of the EU ETS, the Member States developed National Allocation Plans stating the total quantity of allowances they intended to allocate to operators. The Commission developed specific guidance for this[75]. The guidance included descriptions of the main criteria that drive emissions trends, such as GDP growth and carbon intensity, and ways to assess Member States' reduction potential. Based on the reduction potential and the emissions of an appropriate base year, an indicative cap could be calculated.

66
After it had approved the first batch of ten phase II NAPs, the Commission issued a communication[76] in 2006 in which it explained that it used the methodology presented in the European Energy and Transport Trends to 2030 — update 2005[77] as the basis for carbon intensity and economic growth figures needed for calculating the emission caps. The results of this report were derived with the PRIMES-model[78], developed by the University of Athens. However, this assessment method was not communicated in advance (i.e. in the NAP guidelines) to the Member States.

74 Articles 9, 14, 19, 20, 21 and 30 of the EU ETS directive.

75 COM(2005) 703 final of 22 December 2005.

76 COM(2006) 725 final of 29.11.2006.

77 Prepared by the DG Transport and Energy service of the Commission, based on the PRIMES-model.

78 European Energy and Transport Trends to 2030 — update 2005, prepared by the Institute of Communication and Computer Systems of National Technical University of Athens (ICCS-NTUA), Greece for the Commission. PRIMES-model is a general purpose model; it is conceived for projections to the future, scenario building and policy impact analysis. The model considers energy demand and supply technologies and pollution abatement technologies. The system reflects considerations about market economics, industry structure, energy/environmental policies and regulation, which are conceived so as to influence market behaviour of energy system agents (https://ec.europa.eu/energy/sites/ener/files/documents/trends_to_2030_update_2005.pdf).

67
The Court found that the Commission had not been transparent in the decision to use the PRIMES-model as a basis for calculating the phase II caps and 2005 as the base year for these calculations, as Member States had set out to develop their NAPs based on the available NAP guidance without any mention of the PRIMES-model. This led to significant inefficiencies for the Member States as they had to redraft their NAPs using new criteria, and a lack of transparency in the preparation and the assessment of the phase II NAPs.

68
In addition, in order to examine whether the phase II NAPs had been assessed in a consistent, fair, and equally detailed manner, the Court requested the Commission to provide its internal documents and working papers related to the assessment of the phase II NAPs.

69
As the retention period for these documents had expired, the Commission services could only provide the template for the checklists it used, and the completed checklists for two Member States. They could not provide completed checklists for the other Member States. In the absence of available documentation the Court was unable to conclude that the work done by the Commission to assess the NAPs was equally detailed and complete for all selected Member States.

The Commission did not publish the annual implementation reports required under the EU ETS directive

70
Article 21 of the EU ETS directive requires Member States to submit an annual report to the Commission on the application of the directive (also see paragraphs 61 and 62). Based on the reports submitted each year by the Member States, the Commission should publish a consolidated annual report on the implementation of the EU ETS directive within 3 months of receiving the reports from the Member States. In order to be able to publish such a report, the Commission should monitor the timely submission of the Member State reports that serve as input to the consolidated report, and it should develop methods to consolidate and exploit the information received in those reports.

71
The Court noted that the Commission did not publish this annual implementation report during phase II of the EU ETS. This means that during phase II, there has been no comprehensive information made available by the Commission on the state of implementation of the EU ETS across all Member States.

72

Furthermore, the Court found that the Commission services did not adequately monitor the timely and complete submission of the annual implementation reports from Member States, or keep a consolidated record of the received information. The Commission did not systematically exploit this source of information on the implementation of the EU ETS.

The Commission's monitoring of the Member States' implementation of the EU ETS was limited

73

A harmonised implementation by Member States of the emissions trading system is imperative in order to better exploit the benefits of emissions trading and to avoid distortions in the internal market[79]. The EU ETS is largely financed and implemented by the Member States acting under the discretion provided by the directive, and the Court recognises the Commission's limited tools for enforcing harmonisation. Nonetheless, for phase II of the EU ETS, the directive included a number of specific guidance, monitoring and implementation responsibilities for the Commission. In order to know in which areas more harmonisation is required, the Commission should adequately monitor implementation by the Member States.

74

The Court found that in areas where the Commission actively sought harmonisation, for example through adopting guidelines[80], results have been obtained to a certain extent. However, whenever the Commission did not adopt detailed guidelines, key aspects of implementation were not harmonised; for example, account opening (see paragraphs 32 to 36), transaction analysis (see paragraphs 37 to 38), verification and accreditation (see paragraphs 50 to 57), control frameworks and sanctioning regimes (see paragraphs 80 to 85).

75

A consequence of the variety of implementation approaches followed by the Member States is that operators and other market participants in different Member States may be facing different requirements and rules (for example, concerning the legal status of allowances; the application of sanctions; and the monitoring and verification regime), apart from those specifically defined in EU law or guidelines.

79 Recital 8 of Directive 2009/29/EC of the European Parliament and of the Council of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowances trading scheme of the Community (OJ L 140, 5.6.2009, p. 63).

80 E.g. the monitoring and reporting guidelines (MRG) for phases I and II.

76

One way to obtain insight on the level of harmonisation between Member States and to enforce the implementation of harmonised practices is the performance of on-the-spot inspections. The Court recognises that the Commission has no clear mandate to perform inspections at Member State level, but found that there is also no evidence that the Commission duly monitored and assessed the risks (for example, distortion of competition) or potential impact of diverging implementation practices on the effective functioning and integrity of the EU ETS. Although issues of non-harmonisation could be considered a consequence of implementing the EU ETS under a directive, the Court considers that the Commission's monitoring of the level of harmonisation of the implementation in the Member States was limited during phase II of the EU ETS.

The exchange of information organised by the Commission between the Competent Authorities of the Member States on the implementation of the EU ETS was hindered by low participation

77

The EU ETS directive provides that the Commission shall organise an exchange of information between the Competent Authorities of the Member States concerning developments relating to issues of allocation, the use of ERUs[81] and CERs in the Community scheme, the operation of registries, monitoring, reporting, verification and compliance with this directive.

78

In 2009, a Compliance Forum (CF) was established in order to create a platform where Member State Competent Authorities could exchange information on their implementation of the EU ETS. The objectives of the CF cover the proper functioning of processes in the EU ETS compliance chain; assisting Member States in the implementation of EU ETS compliance requirements and processes; and promoting close and effective cooperation between the Competent Authorities in the Member States. The CF was one of the main mechanisms by which the Commission sought to ensure effective exchange of EU ETS information, which is essential in order to share best practices and improve the management of the EU ETS.

79

During phase II of the EU ETS, the CF operated four taskforces. Information discussed and developed in the CF was shared through a web-based facility available to all Competent Authorities. Based on the minutes of these taskforces and interviews with Competent Authorities, the Court found that despite the importance of the role of the Compliance Forum attendance by the Member States was low (with an average of less than six Competent Authorities per session) and only a very limited number of Competent Authorities (mostly the same) regularly participated in the taskforce meetings. This reduced the possibilities to share information among Competent Authorities, an essential element to ensure that the objectives of the EU ETS are achieved.

81 ERUs are Emission Reduction Units generated from Joint Implementation (JI) projects to reduce emissions, CERs are Certified Emission Reductions derived from Clean Development Mechanism (CDM) projects.

Certain weaknesses were found in the national implementation of the EU ETS sanctioning regime and practices for surrendering international project credits

80
In accordance with the EU ETS directive, Member States establish and implement national rules on penalties applicable to infringements of the EU ETS legislation. The EU ETS directive also provides for a specific EU-wide penalty for excess emissions, without prejudice to the additional penalties which Member States may define. This penalty amounts to 100 euro for each tonne of CO_2e for which the operator has not surrendered allowances. As this penalty greatly exceeds the market price for allowances, it acts as an effective encouragement for installations to comply with the cap and surrender sufficient allowances. The Court notes that as regards the EU-wide obligation for installations to surrender the required number of allowances against verified emissions at the surrender deadline in April of each year, the EU ETS has a very high compliance rate (99 % according to publicly available information in the EUTL). The Commission cannot enforce penalties; this is the prerogative of the Member State.

The wide variety of national penalty provisions between Member States potentially does not ensure a level playing field for operators

81
The Court found that the Member States had defined, in their respective national legislation, different types of infringements that could be identified and subsequently sanctioned by means of penalties or other measures (e.g. revoking or temporarily suspending a permit), in addition to the '100 euro' penalty provided for by the directive. The ***Table*** shows a non-exhaustive list of national infringements and the corresponding penalties in some of the Member States audited.

82
The types of infringements that can give rise to a penalty, and the corresponding penalty amounts or sanctions vary widely between the Member States. The Court considers that these non-harmonised practices potentially affect the level playing field for participants.

Table

Non-exhaustive list of national infringements and the corresponding penalties in some of the Member States audited

<table>
<tr><th>Member State</th><th>Infringements
(non-exhaustive)</th><th colspan="2">Fines € (£ for UK)
Min–Max</th><th>Imprisonment (months)
Min–Max</th></tr>
<tr><td>Germany</td><td>Operation without a permit
Omission to notify changes to the installation
Other (5)</td><td colspan="2">5–50 000</td><td>N.A.</td></tr>
<tr><td rowspan="2">Spain</td><td>Operation without a permit
Non-compliance with the obligation to notify any modification to the character, the functioning or the size of the installation that would have a signficiant effect on the emissions or that would require changes to the monitoring
Not presenting an annual verified emissions report
To intentionally withhold or change information in the application for allowances
To deny access to the installation for the verifier</td><td colspan="2">50 001–2 000 000</td><td>N.A.</td></tr>
<tr><td>Non-compliance with the obligation to notify changes to the identity or the place of residence of the operator</td><td colspan="2">10 001–50 000</td><td>N.A.</td></tr>
<tr><td rowspan="2">France</td><td>Operation without a permit</td><td colspan="2">0–150 000</td><td>0–24</td></tr>
<tr><td>Infringement of monitoring and reporting obligations
Omission to notify changes to the installation</td><td colspan="2">0–75 000</td><td>0–6</td></tr>
<tr><td rowspan="3">Italy (2010)</td><td>Operation without a permit</td><td colspan="2">25 000–250 000</td><td rowspan="3">N.A.</td></tr>
<tr><td>Not declaring historical data</td><td colspan="2">2 500–25 000</td></tr>
<tr><td>No declaration of closure</td><td colspan="2">1 000–100 000</td></tr>
<tr><td>United Kingdom</td><td>Operation without a permit
Infringements of monitoring and reporting obligations
Omission to notify changes to the installation
Various other offences including use of false or misleading information</td><td>0</td><td>On summary conviction 5 000 and on indictment</td><td>0–24</td></tr>
</table>

Source: Information obtained from relevant Member State Article 21 reports for phase II.

There was a lack of consolidated information on the enforcement of penalties by the Member States

83
In most of the Member States audited, with the exception of Germany and the United Kingdom, there was a lack of up-to-date information on the state of implementation or outcome of EU-wide penalties and the additional national penalties. There was incomplete information on the number of penalty procedures that had been initiated during phase II and successfully implemented (i.e. where payment was confirmed). The Court noted that Member States were often confronted with limitations in their own legal and administrative environment for the successful implementation of EU ETS penalties. Competent Authorities were either not empowered to impose sanctions themselves (e.g. Italy) or needed to await the outcome of lengthy Court procedures and appeals (e.g. in Germany). This may have discouraged Competent Authorities from pursuing new penalty procedures. Furthermore, the absence of comprehensive reporting on the implementation of penalties does not reinforce the dissuasiveness of such a system.

84
The Court further found that the Commission, for the purpose of monitoring the implementation of the EU ETS, does not maintain an EU ETS specific overview of national penalties and does not gather statistics on the application of penalties throughout the EU.

85
Overall, the Court could not assess the implementation of penalty procedures by the Member States, due to a lack of consolidated information at Member State and at European level.

Specific issues concerning the surrendering of international project credits

86
The percentage limits for the use or surrendering of international project credits from Joint Implementation (JI — ERU) and Clean Development Mechanism (CDM — CER) (see ***Part I of the Annex*** for further background information) varied between the Member States, but were established in the respective National Allocation Plans for phase II. If individual operators are allowed by their national Competent Authority to exceed the limit for surrendering international credits for their installations, this potentially affects the level playing field for operators. In 6 %[82] of 150 cases examined by the Court, the national percentage limits for surrendering international project credits were exceeded by operators. ***Box 8*** provides more detail on some of these cases:

82 France (five cases), Greece (three cases) and the United Kingdom (one case). It was financially interesting for operators to surrender Kyoto Protocol project credits instead of European Union Allowances (EUAs), especially towards the end of phase II, when they were much cheaper than EUAs. Use of these project credits for compliance with the EU ETS was restricted in phase III. Consequently their use by operators increased exponentially towards the end of phase II — see ***Figure of the Annex***.

Box 8

Excess surrendering of international credits

In phase II, the limit for surrendering international project credits was expressed as a percentage of the total allocation for an installation.

In France, the EUTL did not reflect an increased allocation of allowances following production increases for five installations out of 20 examined for the years 2008–10. With the increased allocation, the absolute amount of international credits that could be surrendered had also increased. The operator used this opportunity by surrendering more international credits. However, since the Member State failed to notify the Commission of these production increases and subsequent allocations from the national entrants' reserve, the Court's calculations of surrendered international credits based on EUTL data exceeded 13,5 %, which was the limit in France.

In the United Kingdom, the Court found one case where the limit for surrendering international project credits was exceeded. When an operator closed one of its installations (for which an allocation had already been assigned), the operator was granted permission from the authorities to retain all allocated allowances for the closed installation and transfer the allowances with the corresponding limit of project credits (i.e. 8 %) to another of its installations. The Court calculated that the installation that received the transferred allowances surrendered more than the allowed 8 % of its allocated allowances in project credits. The Court found that the operator had only partially maintained the capacity of the closed installation and transferred it to the remaining installation. Since the operator received permission to surrender project credits for the total amount of allocated allowances, the limit was exceeded. The Court found that this practice potentially gave rise to different treatments of operators within the same sector.

Conclusions and recommendations

87
The EU ETS is the cornerstone of the EU's climate policy and is often quoted as the reference model for emerging climate change policy and emissions trading schemes elsewhere in the world. This innovative scheme introduced in 2005 and progressively improved is now in its third phase of implementation. At European level, the goal of the EU ETS, as a market-based mechanism, is not just reducing emissions in line with the cap, but also establishing a pricing mechanism for carbon. A higher price creates a greater incentive to invest in low-carbon technologies[83]. For the EU ETS to work as intended, it is also necessary that the integrity of the system is ensured, and that the scheme is correctly implemented. Previous incidents including alleged theft of allowances and VAT carousel fraud further demonstrate the need for vigilance.

88
The audit therefore assessed whether the EU ETS was managed adequately, by examining whether the framework developed for protecting the integrity of the EU ETS is sufficiently robust to enable the EU ETS to function well, and whether the EU ETS was correctly implemented in phase II.

89
Overall the Court concluded that the management of the EU ETS by the Commission and Member States was not adequate in all respects. It was hindered by certain issues related to the robustness of the framework for protecting its integrity, and by significant weaknesses in the implementation of phase II of the EU ETS.

90
Although there have been significant improvements to the framework for protecting market integrity (paragraphs 14 to 17), notably through the inclusion of most of the spot market for allowances under the MiFID and MAD regimes, a number of weaknesses remain to be addressed in order to make the framework sufficiently robust, and to encourage investor confidence, to leverage the EU ETS as a tool of environmental policy.

91
The audit found that there are remaining issues in regulation and oversight of the emission market related to compliance traders, bilateral OTC spot trading and smaller market participants (paragraphs 18 to 21), despite the qualification of emission allowances as financial instruments. Although the Registry was centralised in 2012, there is no EU-level oversight of the emissions market and procedures for cooperation involving national financial regulators and the Commission are not sufficiently clear (paragraphs 22 to 24). There is therefore a risk that market distortions or anomalies with potentially serious effects are not appropriately managed.

83 European Commission Climate Action, 'The EU Emissions Trading System (EU ETS)' factsheet, available at http://ec.europa.eu/clima/publications/docs/factsheet_ets_en.pdf.

Recommendation 1

Remaining issues in emission market regulation and oversight should be addressed by the Commission in order to further improve market integrity. The Commission should:

(a) in the context of the relevant future review of the MiFID and MAR legislation, analyse the potential risks related to regulatory exemptions for compliance traders and smaller participants on the emissions market to determine whether action is required to address them;

(b) ensure that taking account of the evolving EU financial markets regulation (e.g. MiFID and MAR) over the emissions market, the emissions market is subject to adequate EU-level supervision;

(c) strengthen the regulatory cooperation mechanisms to ensure improved market oversight.

92

The Court considers that more clarity in the legal definition of emission allowances could be beneficial to the functioning of the EU ETS market (paragraphs 1 to 27). In order to support the liquidity of the emissions market, confidence is needed, particularly from investment traders who are not obliged to continue participating in this market. More clarity regarding the creation and protection of security interests in allowances also has the potential to contribute to a better functioning of the market (paragraph 28).

Recommendation 2

The legal status of allowances should be further clarified in order to contribute to stability and confidence.

In this context, the Commission should analyse the benefits of treating emission allowances as property rights across the EU and consider how to provide an express registration mechanism for security interests.

93

The Union registry is a key tool for processing and disclosing fundamental EU ETS data, and for ensuring the integrity of the EU ETS market. Due to the significant financial stakes and wide range of participants, it has a high risk profile (paragraphs 29 to 31). In order for the market to be secured at EU level, and in light of the previous security incidents affecting the market, there is a need for a harmonised approach to risk management procedures.
The security of the registry has been significantly improved over phase II of the EU ETS (paragraph 32). However, the procedures in most of the Member States audited to control the opening of EU ETS accounts, monitor transactions, and cooperate with regulatory authorities are not sufficiently robust (paragraphs 33 to 38). As the Commission also cannot adequately monitor transactions due to data protection considerations, this represents a significant supervisory gap. At the Commission, the development and operation of the Registry has been a complex project which was hindered by internal coordination issues and resource constraints (paragraphs 39 to 41).

Recommendation 3

Certain aspects of the systems for processing fundamental EU ETS information (the EU Union Registry and related procedures) should be further improved.

The Commission should:

(a) consider how effective cross border transaction monitoring can be developed and coordinated at EU level to mitigate risks of abuse and fraudulent activities;

(b) identify appropriate measures to enhance the control framework and promote best practices by Member States on the opening of accounts to further mitigate security and integrity risks, and ensure that these are implemented across the EU;

(c) provide an appropriate structure for the IT and business duties in the relevant Commission service and ensure the good functioning of the registry system.

Member States should:

(d) implement the controls identified at recommendation 3 (b); and

(e) improve cooperation between authorities responsible for the Union Registry, and other competent authorities, notably financial intelligence units and law enforcement bodies.

94

The Court concludes that significant weaknesses affected the implementation of the EU ETS in phase II. Member States chose to implement the EU ETS directive in different ways (paragraph 47). There were weaknesses in the Member States' implementation of the control framework. Systems for monitoring, reporting and verification of emissions were not sufficiently harmonised nor implemented effectively (paragraphs 48 to 60). In particular, Competent Authorities did not sufficiently check the work performed by verifiers, and performed limited on-the-spot checks at installation level. Some Member States also did not provide all required reports on the operation of the EU ETS (paragraphs 61 to 63).

Recommendation 4

The weaknesses identified by the Court's audit of the implementation by Member States of the control framework in phase II, should be addressed during the implementation of the revised framework for phase III.

The Commission should:

(a) consider whether further amendments to the monitoring and reporting framework are required to strengthen the monitoring, reporting and verification of emissions;

(b) require Competent Authorities to improve enforcement practices in order to give assurance on the quality of the control framework.

The Member States should:

(c) implement coherent, effective control frameworks, including inspections, for monitoring, reporting and verification activities;

(d) ensure better coordination and exchange of information between the Competent Authorities and Accreditation bodies, to improve the quality of the verification process;

(e) provide on time to the Commission the annual reports foreseen by the directive; and

(f) regularly publish reports on the implementation and results of EU ETS to encourage transparency for operators and market participants.

95

The Court found gaps in the Commission's guidance and monitoring of Member States' implementation during phase II of EU ETS. The Court found that the lack of transparency in the Commission's decision to use the PRIMES-model and 2005 as the base year to calculate phase II emission caps led to inefficiencies for the Member States and a lack of transparency in the preparation and the assessment of the phase II NAPs (paragraphs 65 to 67). In the absence of specific internal Commission documents related to the assessment of the NAPs, the Court was unable to conclude that the work done by the Commission to assess the NAPs was equally detailed and complete for all selected Member States (see paragraphs 68 and 69).

96

The nature of the EU ETS as a market-based mechanism requires the regular disclosure of detailed and relevant information on the implementation and functioning of the system. Although a lot of information is publicly available, the Commission did not publish one important piece of such information, the annual implementation report required under the directive (see paragraphs 71 and 72). Coordination and exchanges of information between the Member States are also vital. The Commission has had a limited role in ensuring the harmonisation of key controls in the implementation of the EU ETS by Member States (paragraphs 73 to 76). Various fora and working groups to share information were established and these provided essential support to Member States. However, their impact was limited to some extent by a relatively low level of participation by Member States (paragraphs 77 to 79).

Recommendation 5

During phase III, the level of guidance and information about the implementation of the EU ETS should be improved. The Commission should:

(a) improve its monitoring of the implementation by the Member States to identify areas where more harmonisation is imperative; and

(b) publish regularly the required report on the implementation of the EU ETS, specifically addressing issues of non-harmonisation and resulting risks.

The Member States should:

(c) ensure that representatives of Competent Authorities regularly attend meetings and participate in the exchange of information, experiences and knowledge on implementation issues.

97

As regards the EU-wide obligation for installations to surrender the required number of allowances each year, the EU ETS has a very high compliance rate. Nevertheless, the Court noted that Member States defined a wide variety of penalty provisions for other types of infringements, which potentially reduces the level playing field for operators (paragraphs 81 and 82). The Court could not assess the effectiveness of the sanction systems of the Member States due to a lack of consolidated information at Member State and European level. The effective implementation of penalties was sometimes hampered by limitations in the legal and administrative systems of the Member States (paragraphs 83 to 85). Furthermore, there were divergent practices concerning specific rules for the surrendering of international project credits (paragraph 86). These issues potentially affect the level playing field for operators.

Recommendation 6

The implementation of sanctions in relation to the EU ETS should be made more transparent. Up-to-date and accurate information should be available at Member State and EU level on the implementation and results of penalty procedures, and the Commission should better monitor enforcement practises across the EU as well as the consistent application of national penalties.

The Commission should:

(a) ensure that Member States keep up-to-date information on the application of all types of penalties (EU and national) and make appropriate proposals and guidelines for increased transparency among relevant bodies.

The Member States should:

(b) consistently apply the penalties defined at national level as well as the penalty foreseen in the Directive; and

(c) keep up-to-date and accurate information on penalties applied.

This report was adopted by Chamber I, headed by Mr Augustyn KUBIK, Member of the Court of Auditors, in Luxembourg at its meeting of 15 April 2015.

For the Court of Auditors

Vítor Manuel da SILVA CALDEIRA
President

Background information

PART I — International framework for emissions trading

1. There is widespread scientific consensus that greenhouse gases generated from human activity and released into the atmosphere have a direct impact on the greenhouse effect, causing global warming and affecting the climate system. This consensus also holds that if global average temperature increases by 2 °C compared to the temperature in pre-industrial times, there is a much higher risk that dangerous and possibly catastrophic changes in the global environment will occur. Therefore, the international community recommends keeping warming below 2 °C by reducing these emissions[1].

2. The European Union has shown international leadership in its actions to deal with climate change. It has committed itself to reduce GHG emissions under the 1997 Kyoto Protocol (see ***Box***) to the 1992 UNFCCC that sets an overall framework for intergovernmental efforts to tackle the challenge posed by climate change.

Box — The Kyoto Protocol

The **Kyoto Protocol** was adopted in Kyoto, Japan, on 11 December 1997 and entered into force on 16 February 2005. 188 countries and one regional economic integration organisation (the European Union) have signed up to the protocol. Of the UNFCCC signatories only the United States has not ratified the protocol. The protocol set an objective for the 37 industrialised countries and the European Union: a binding reduction target of GHG emissions by an average of 5 % compared to 1990 levels over the 5-year period 2008 to 2012. The Kyoto Protocol introduced three market-based mechanisms to help meet these targets: emissions trading, the Clean Development Mechanism and Joint Implementation.

3. The Commission's long-term roadmap for GHG emissions aims at a reduction of 80 % by 2050[2]. On 23 October 2014, the Council agreed on the 2030 climate and energy policy framework and endorsed a binding EU target of at least 40 % domestic reduction in greenhouse gases by 2030 compared to 1990[3]. The EU ETS will continue to play a central role in achieving these objectives.

---

1 See Intergovernmental Panel on Climate Change (IPCC), established by the United Nations Environment Programme and the World Meteorological Organisation in 1988 (www.ipcc.ch).

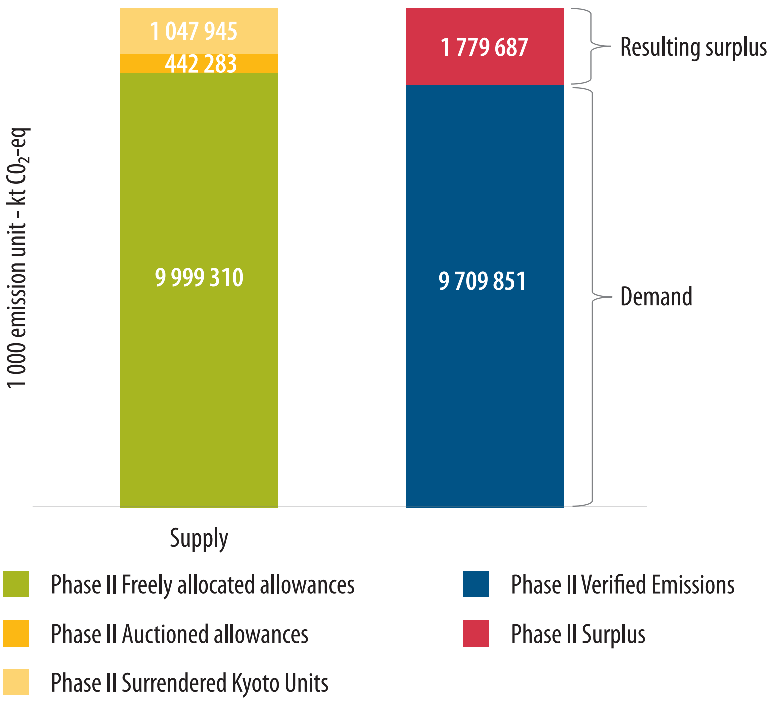
2 COM(2011) 112 final of 8.3.2011, 'A Roadmap for moving to a competitive low carbon economy in 2050'.

3 European Council (23 and 24 October 2014), Conclusions on 2030 Climate and Energy Policy Framework, SN 79/14.

PART II — Supply and demand in the EU ETS during phase II (2008–12)

4. The economic crisis, which started around 2008, strongly reduced industrial activity and emissions[4]. The demand for allowances in phase II was therefore lower than expected creating a surplus of allowances on the market (see ***Figure***) and impacting on the carbon price, which fell from approximately 22 euros to 5 euros between the start of phase II in 2008 by the end of phase II in 2012.

Figure — Supply, demand and surplus for phase II of the EU ETS (2008–12)



Source: ECA's analysis based on EEA ETS Dataviewer (June 2014) for stationary installations.

4 The link between the economic crisis and the fall in emissions has been identified by the Commission ('The state of the European carbon market in 2012', COM(2012) 652 final) and by extensive other sources (for example, the World Bank in its report 'Mapping Carbon Pricing Initiatives' of 2013).

PART III — Debates on reform to mitigate surplus allowances and future perspectives

5. Debates on further changes to the EU ETS and structural reform from 2020 onwards are still ongoing. In phase II, there was little flexibility in the system to respond to the changing economic situation, the reduced demand for allowances and the growing surplus. This was recognised by the Commission as weakening the effectiveness of the scheme. The Commission also considers that a higher market price would create a greater incentive to invest in low carbon technologies[5]. In an attempt to mitigate the effects of the surplus of EU ETS allowances (identified by the Commission at almost 2 billion allowances at the start of phase III[6]) (see also Figure) and to strengthen the price signal on carbon emissions, the Commission issued in 2012 a proposal for the 'back-loading' of auctions for phase III. The auctioning of 900 million allowances would be postponed until 2019–20. Back-loading would not reduce the overall level of allowances available, but would modify their distribution over the period. This legislative proposal was accepted by the Parliament and the Council during 2013.

6. In order to tackle the issue of the surplus and to strengthen the environmental impact of the scheme, the Commission considered that a sustainable solution to the imbalance between supply and demand was required. In January 2014, the Commission therefore proposed — together with the proposal for the 2030 climate and energy package[7] — structural reform measures for the EU ETS, with the introduction of a market stability reserve from 2021 to address the surplus of allowances already built up and to improve the system's resilience to major shocks by automatically adjusting the supply of allowances to be auctioned. The legislative proposal is under consideration by the Council and the European Parliament.

5 European Commission Climate Action, 'The EU Emissions Trading System (EU ETS)' factsheet, available at http://ec.europa.eu/clima/publications/docs/factsheet_ets_en.pdf

6 European Commission, DG Climate Action (http://ec.europa.eu/clima/policies/ets/reform/index_en.htm).

7 COM(2014) 15 final of 22.1.2014, 'A policy framework for climate and energy in the period from 2020 to 2030'.

Reply of the Commission

Executive summary

II

The EU ETS is the cornerstone of EU climate policy. The system has put a price on carbon and emissions from installations in the system are falling as intended: by 2012 they were down 19 % compared to 1990 levels.

The EU ETS delivers the necessary emission reductions at low cost. No other policy measure, be it taxation or regulation, guarantees this like emissions trading does.

The success of the EU ETS has inspired others worldwide and the Commission will continue to promote ETS as a policy measure.

III

While the Court focused the audit on phase II of the EU ETS (2008–12), many improvements are already in place for phase III (2013–20) and specifically address the observations noted by the Court. Such observations are thus appreciated as further support for the related developments already put in place for phase III and further food for thought in other cases.

IV

The Commission takes note of the Court's conclusion.

The Commission stresses that in phase II the management of the EU ETS was hindered by some issues relating to the robustness of the framework for protecting its integrity. The fact that there were weaknesses in the implementation of the EU ETS in phase II is one of the important reasons for the careful considerations given to the new developments and improvements now being implemented in phase III.

V

Any significant remaining issues in emission market regulation and oversight should be addressed where necessary in order to improve market integrity. To ensure that EU action is required and effective, the Commission assesses the impact of its policies and proposals at every stage, from proposal to implementation to review. An evaluation of the recently adopted rules on emission market regulation and oversight, which are currently subject to ongoing implementation, may take place in the context of the reports to be submitted by the Commission to the European Parliament and the Council in 2019 under Article 90 of MiFID II[1] and Article 38 of MAR[2].

V (a)

The Commission and the co-legislators thoroughly analysed potential risks regarding the regulation and oversight of the emission market related to compliance traders, bilateral over-the-counter (OTC) spot trading and smaller market participants during the adoption process for MiFID II (hereinafter referred to as 'MiFID'), which contains therefore a well balanced regime for exemptions. The exemptions mentioned in Articles 2(1)(e), 2(1)(j) and Article 3(1)(e) of MiFID are subject to conditions and regulatory oversight and are not necessarily specific to emission allowances but apply equally to commodity derivatives. The reasons for the exemptions result from an assessment of the purpose of requiring a MiFID authorisation (principally to protect clients of investment firms in cross-border transactions) as well as their proportionality with regards to the costs of obtaining such authorisation versus its benefits for the exempted persons.

1 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

2 Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC.

V (b)
The supervisory framework established by EU financial markets legislation, which is also used for all commodity derivatives traded in the EU (e.g. MiFID position reporting, MAR sets out far-reaching cooperation mechanisms) applies to the emissions market.

The regulatory cooperation mechanisms will come into full force and effect as of 2017.

V (c)
Analysis of the EU carbon market generally shows that the market has grown and matured, despite the facts that the legal status of allowances is not defined at EU level and that the creation and protection of security interests in allowances is not expressly provided for.

V (d)
Building on the progress made in phase II, the Commission will ensure continual improvements as required to maintain the security of the Union Registry to the highest standard.

The legislation does not provide for the Commission to monitor transactions in the Union Registry. The EU-level supervision of the European carbon market can be improved to detect abuse and fraudulent activities, but this issue is wider than the Registry which only records information about the physical transfers of carbon units and not the financial leg.

VI (a)
Commission regulations have been adopted to improve even more the effectiveness, efficiency and harmonisation of EU ETS monitoring and reporting and verification and accreditation in phase III.

VI (b)
Commission Implementing Decision 2014/166/EU and an associated explanatory note have relaunched the system requiring Member States to submit annual 'Article 21' reports to the Commission on their implementation of the EU ETS directive. These reports are publicly available via the European Environment Agency's ReportNet system.

VI (c)
The Commission recognises that there was some incompleteness in the submission of Article 21 reports during phase II. Requirements are now being more rigorously implemented for phase III based on Commission Implementing Decision 2014/166/EU.

VI (d)
The Commission continues to coordinate frequent exchanges with and between Member States in the form of well-attended meetings with published proceedings and consultations.

VI (e)
The Commission considers that it continues to play a major role in driving harmonisation of key controls in the implementation of EU ETS through the regulatory framework and supporting guidance and templates as well as through appropriate conferences, meetings and consultations.

VI (f)
Overviews of the EU ETS sanctioning systems within Member States are being acquired as part of the Commission's Member State EU ETS compliance review studies and Commission Implementing Decision 2014/166/EU updating the system requiring Member States to submit annual 'Article 21' reports to the Commission on their implementation of the EU ETS directive.

In phase III, each operator can use international project credits up to a certain limit, determined on the basis of the rules defined in Commission Regulation (EU) 1123/2013.

VII 1.
The Commission partly accepts the recommendations and agrees that any significant remaining issues in emission market regulation and oversight should be addressed in order to improve market integrity where necessary.

VII 2.
The Commission accepts the recommendation and will analyse the benefits of clarifying the legal status of allowances.

VII 3.

The Commission accepts the relevant recommendations. The security of the registry system has been significantly improved since 2012 and the Commission will strive to further improve the system on the aspects identified by the Court.

VII 4.

The Commission accepts the relevant recommendations. The specific roles and responsibilities of all parties involved in EU ETS are clarified as the result of the Commission regulations on accreditation and verification and monitoring and reporting adopted for phase III.

VII 5.

The Commission accepts the relevant recommendations and that the level of guidance and information about the implementation of the EU ETS as implemented in phase II could have been better. It considers that the situation has been duly improved for phase III.

VII 6.

The Commission considers the EU ETS sanctioning system effective. The penalty of €100 per tonne of CO_2 emitted for which no allowances are surrendered by 30 April has a strong deterrent effect. This is in particular demonstrated by very high compliance rate.

Member States should be transparent on the sanctions that apply at the national level and should also publish the information on operators in breach of the surrender obligation.

The Commission accepts the relevant recommendation and attaches importance to transparency between Member States' Competent Authorities to maintain the very high compliance rate.

Introduction

Box 2

The EU ETS faced various risks which were addressed by specific actions. VAT carousel fraud in the carbon market was addressed by the possibility for Member States to apply a reverse charge mechanism. Several national registries were the target of IT attacks and security of the registry system was improved following the centralisation of operations in a single Union registry. Finally the regulation and oversight of the carbon market were strengthened.

15

The Commission notes that the Court has explicitly stated that the question of which regulatory approach would be best suited to the emissions market was beyond the scope of this audit.

The Commission considers that the remaining issues that ought to be considered for further regulatory action should be examined taking into account the regulatory framework for emission allowances once they become financial instruments in 2017.

16 - Reply to first indent

Upon the Commission's proposal, the Council adopted Council Directive 2010/23/EU[3], which provided (in Article 199a) the possibility to apply the reverse charge mechanism for the transfer of emission allowances. The application period of this directive was extended until 31 December 2018[4].

16 - Reply to third indent

Regulation (EU) 389/2013 (registry regulation) does not contain a direct reference to the substantive provisions of the anti-money laundering directive, but provides an ad hoc regime for national registry administrators based on a harmonised set of know-your-customer checks and other relevant requirements, which therefore establishes directly applicable EU-level harmonised rules in this area.

3 Council Directive 2010/23/EU of 16 March 2010 (amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain services susceptible to fraud (OJ L 72, 20.3.2010, p. 1)).

4 By Council Directive 2013/43/EU of 22 July 2013 (OJ L 201, 26.7.2013, p. 4).

Box 3 - Reply to second paragraph

The Commissioners in charge of, respectively, the ETS and VAT policies sent a joint letter in June 2011 to all Member States that did not yet apply the reverse charge mechanism, asking them to put national provisions in place. This demonstrates that the issue has been addressed at the highest possible level.

Box 3 - Reply to third paragraph

Italy's legislation provides for the reverse charge mechanism for emission allowances as from 1 January 2015.

18

Compliance buyers need to participate in the carbon market, if their emissions exceed their free allocations. They can buy through banks or investment firms, which are regulated under MiFID. MiFID (applied in conjunction with MAR and European market infrastructure regulation (EMIR)[5]) aims to improve market stability and integrity, including reducing systemic risks while considering cost-effectiveness and proportionality of EU legislation.

19

The exemptions cover 'non-financial' entities that trade allowances. This is similar to exemptions in other rules on financial markets, e.g. exemption from the clearing obligation for non-financial counterparties under EMIR, or those applying in commodity derivatives. They are not 'blanket' exemptions but are subject to conditions and/or oversight by national competent authorities and also at EU level. In some cases the exemptions are national in scope and do not have any cross-border effects.

Even where entities are exempt under MiFID, many of them will nonetheless remain subject to obligations under MAR relating to insider trading and market manipulation.

The Commission's proposal was endorsed by the co-legislators, who clearly approved and confirmed this approach and if anything, broadened the exemptions' scope.

Taking into account the proportionality principle, the Commission considers that in relation to the objectives of the authorisation under MiFID; its respective costs versus their benefits; its regulatory burden, the exemptions for compliance buyers represent the least onerous means to achieve the desired outcome.

Furthermore, exempted entities would still be covered by the scope of MAR.

20

Concerning OTC derivatives, EMIR imposes obligations on certain market participants that enter into derivatives trades, and as such they would be regulated[6].

Several studies indicate that the share of OTC spot contract volumes which are not cleared were around 1 % in 2010. Analysis of available data on more recent market evolution supports the conclusion that this share is likely even lower now[7].

Moreover, purely bilateral OTC trades will still be covered by the scope of MAR, which explicitly specifies that it 'applies to any transaction, order or behaviour concerning any financial instrument as referred to Article 2(1) and (2), irrespective of whether or not such transaction, order or behaviour takes place on a trading venue.'

5 Full name Regulation on OTC derivatives, Central Counterparties and Trade Repositories (Regulation (EU) No 648/2012).

6 Almost all responses to the consultation by the European Securities and Markets Authority (ESMA) on the related draft clearing thresholds for application suggested that they should be increased, claiming that the non-financial firms pose negligible risk of a systemic nature to the financial system due to lack of their interconnectedness. The same can be said about non-financial firms when it comes to their trading in purely bilateral OTC spot emission allowances.

7 Commission computations based on Bloomberg New Energy Finance's data on total EUA market size and its split by Auctions, Exchanges and OTC, coupled with estimate by London Energy Brokers Association (LEBA) on the share of OTC EUA trades which were for spot products in 2010, and with LEBA data for 2010–14 on share of OTC trades which were not cleared.

21
In October 2013, the Commission requested ESMA to provide advice to assist it on the content of the delegated acts required by some provisions of the MAR, including on the level of the thresholds in terms of carbon dioxide equivalent emissions and of rated thermal input.

The majority of the respondents to the related ESMA consultation argued that there is little or no relevant entity specific information that is not already published under other rules, notably the regulation on wholesale energy market integrity and transparency (REMIT).[8]

Any potential cumulative impact on the emissions market would only be material to the extent that a sizeable proportion of smaller market participants coordinated their activities, which would not only be an anti-trust matter subject to anti-trust supervision, but would also be difficult for them to sustain on account of their large numbers.

22
The Commission agrees that further work could be done on regulatory cooperation mechanisms in the supervisory framework for the emissions allowances market. However the existing provisions on mechanisms will come into full force and effect only as of 2017. Therefore, any future work should focus on options to strengthen the existing systems, wherever needed based on a clear evaluation of the magnitude of any remaining risks to the EU ETS or the European carbon market and to do so in the most cost-effective and proportional manner.

23
The supervisory framework established by EU financial markets legislation is also used for all commodity derivatives traded in the EU (e.g. MiFID position reporting, MAR sets out far reaching cooperation mechanisms). A review has not provided elements to support the position that this framework is not adequate for the emissions market compared to commodity derivative contracts generally.

8 Regulation (EU) No 1227/2011.

With respect to MAR, competent authorities exercise their functions and duties stemming from MAR in collaboration with other authorities or with the market undertaking. MAR competent authorities are required to cooperate with ESMA, including with respect to the exchange of necessary information, and with competent authorities of EU Member States.

As regards the Union Registry and the Commission's powers, national financial regulators can obtain information on transactions in the Union registry from the relevant national administrator or the Commission as central administrator (which can provide data concerning several or all Member States), in accordance with Article 110(2) of Regulation (EU) 389/2013. It is also worth noting that 30–40 % of emission allowances futures are not held to maturity and therefore are not physically settled and hence not visible in the Union Registry.

24
The Commission notes that the supervision of the emissions' market rests with national regulators. Integrated procedures between national regulators for organising EU-level supervision of the emissions market are established by the revised MiFID and MAR laying down detailed rules on cross-border cooperation between national competent authorities and between them and ESMA and EU level as well as with third countries worldwide.

In addition an extensive surveillance, data reporting, and supervision framework (at national and EU level) will be implemented under the revised MiFID/MiFIR[9] and MAR/MAD regimes, applicable to emission allowances as of January 2017 and July 2016 respectively.

The frequency and structure of the existing formal and informal contacts amongst services within the Commission are sufficient for and proportionate to the overall regulatory tasks.

9 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

25
The EU carbon market has grown and matured, despite the fact that the legal status of allowances is not defined at EU level. The factors driving liquidity are largely economic rather than legal in nature[10].

The Commission believes that Directive 2003/87/EC and its implementing legislation notably Article 40 of Regulation (EU) 389/2013[11], as well as the evolving framework for EU financial markets regulation[12] provide the necessary legal underpinnings for a transparent and liquid EU carbon market whilst ensuring the market's stability and integrity.

26
In accordance with Article 345 of the TFEU, under Union law property law is the prerogative of the Member States. This is all the more so in relation to mandating the creation of property rights at EU level with respect to a class of assets where there are no pre-existing property rights in the Member States as the Court has found.

The existence of a specific property law regime of trading assets is very much the exception rather than the rule for the vast majority of assets being transacted including financial instruments. However, this does not mean that the normal principles of national contract and property law do not necessarily apply to transactions in such assets[13]. Directive 2003/87/EC and its implementing legislation govern all the important legal characteristics relating to the exercise of rights over allowances.

10 The Commission has already proposed to establish a market stability reserve (COM(2014)20) to address surplus allowances and improve the system's resilience to major shocks by adjusting the supply of allowances to be auctioned, which is being discussed by the European Parliament and the Council.

11 Allowances may be held by anyone, but title can be determined by reference to the Union Registry since the record of the registry constitutes prima facie and sufficient evidence of title over an allowance.

12 As of 2017, emission allowances will have the status of financial instruments within the EU and be subject to the framework for EU financial markets regulation.

13 There is, for example, no specific legal regime for money held in a bank account. As such the account holder does not own the money in its account, but merely has a legal claim to it, yet this has not precluded the development of financial markets based on money not only within the EU but worldwide.

Rights to hold, transfer, surrender and cancel allowances are fully guaranteed by Directive 2003/87/EC and also fully supported by the Union Registry within which they can be exercised.

27
In the light of the foregoing, the Commission considers that legal interests are duly protected and allowances can be contested as civil matters in national courts. Nevertheless, the Commission will endeavour to analyse the potential benefits of further clarifying the legal status of allowances in EU law for the functioning of the EU ETS and the European carbon market.

28
The Commission will consider the legal and technical feasibility of facilitating the registration of security interests in allowances, in the light of the public policy objectives of the EU ETS.

30
The Commission considers that the Union Registry introduced improvements to address past weaknesses identified under the decentralised phase II system of national registries. Additional actions were also taken subsequently in phase III of the EU ETS, following the revision of the EU ETS directive in 2009. No incident has been reported since the launch of the Union Registry in 2012 and data held in the Union Registry or the EUTL are provided to national law enforcement bodies during formal investigations or legal proceedings.

The Commission agrees that supervision of the carbon market can be improved. The Union Registry does not contain financial information and therefore data in the Registry would be of limited use to supervise financial transactions.

Furthermore in accordance with the relevant primary legislation and Regulation (EU) 389/2013, the Commission has no legal basis to perform analysis on the Member States' data stored in the Union Registry.

The Commission has actively supported the Member States in implementing cooperation with Financial Intelligence Units.

31

The Commission considers that the registry systems steadily improved over time and that many issues noted by the Court are addressed in phase III.

32

Regarding KYC-checks and practices, Regulation (EU) 389/2013 enumerates exhaustively the conditions and documents for the opening of accounts of compliance participants. However the requirements for accounts of voluntary participants stipulate only the minimum requirements for account opening.

34

The requirements set by Regulation (EU) 389/2013 for voluntary participants provide room for Member States to apply appropriate risk assessment practices.

35 - Reply to second indent

Regulation (EU) 389/2013 lists what information on suspicious applications for account openings is shared between national administrators. The establishment of a permanent EU-wide list of refused account openings raises issues with regards to the legal framework on the protection of personal data.

36

Directive 2003/87/EC and Commission Regulation (EU) 389/2013 entrust the management of users' registry accounts to Member States in line with the principle of subsidiarity. The role of the Commission as central administrator is to operate and maintain the Union Registry. The Commission coordinates the implementation of the relevant legal provisions by organising exchanges of information and best practices on know-your-customer checks, in particular within the Registry Administrators' Working Group, with particular emphasis on methods and tools that can be implemented within the existing legal framework.

37

The supervision of the European carbon market at EU level could be further improved, including by using the relevant data from the Union Registry. However, the Union Registry only records information about the physical transfers of carbon units and does not record any information about the financial leg of the transactions, which is not sufficient to detect abuse or fraudulent activities.

38

The analysis of cross-border transactions was not possible before the migration to the Union Registry as national registries were operated by individual Member States and not consolidated.

In the current legal framework, the Commission is providing the Union Registry application, but does not have a role to actively supervise transactions in the Union Registry by exploiting the data held on behalf of the Member States.

41

The Commission considers that its organisational structure is adequate. The segregation of roles between business/policy owner and IT supplier has been implemented since 2014 in accordance with the relevant project management methodology and the resources and skills have been further optimised to ensure an adequate internal organisation.

The implementation of the action plan following the IT audit by the Commission's Internal Audit Service addresses the identified weaknesses and will increase the effectiveness of the registry development and management.

50

Box 4 in the Court's report names the main aspects relevant to monitoring, reporting and verification. While some form of competent authority check of verified annual emission reports might reasonably be expected, Directive 2003/87/EC and implementation measures do not explicitly require this. Full duplication of verification would be counter-productive including in terms of added costs.

51

Specified mandatory content and a standard template for the EU ETS verification report are now in place for phase III. The legislation at the European level for EU ETS phase II did not allow for a standard template.

52

The Commission agrees that a lack of follow-up on verifier findings existed in phase II. For phase III operators are now required to submit an improvement report for approval by the Competent Authority concerning all non-conformities and recommendations reported by the verifier. The Commission also published guidance directing verifiers on how to handle repeated findings.

Box 7

The verification report template now published by the Commission indicates the minimum that is mandatory for inclusion in Member State verification report templates for phase III and includes specific provision for the verifier to note recommendations.

For phase III, additional responsibilities for accreditation and verification and for national accreditation bodies to carry out ongoing surveillance of the verifiers are in place. One of the main purposes of this ongoing surveillance is to check continued competence of the verifier looking out in particular for inconsistencies such as a verifier who never reports non-conformities or recommendations or between the internal verification documentation and the issued verification report.

53

The guidelines for monitoring and reporting in phase II included specific definitions for phase II concerning both the required 'verifier' (Section 2(5)(m) of Annex I of Commission Decision 2007/589/EC) and 'accreditation' (Section 2(5)(k) of Annex I of Commission Decision 2007/589/EC), before pointing to relevant European cooperation for Accreditation guidance. The guidelines also included provision for accreditation bodies as well as competent authorities to gain access to evaluate the verifier's internal verification report. However, the need to ensure much greater harmonisation in EU ETS verification and accreditation is the main reason why Regulation (EU) 600/2012 concerning EU ETS accreditation and verification has been adopted for phase III.

56

The roles of individual entities in EU ETS are based on their respective competences. Verifiers are foremost competent for verification (not the regulatory authorities). National accreditation bodies are competent and empowered to accredit verifiers (not the regulatory authorities). Designated competent authorities are competent and empowered for general implementation of EU ETS (not verifiers or national accreditation bodies). Coordination between the different entities is important for promoting effective implementation of EU ETS overall, but this needs to be proportionate according to competence and to avoid inefficient and counter-productive duplication and addition of costs.

57

The Commission considers that the situation reported where verifiers are involved in verifications as well as in the development of the monitoring plans for the same site is a conflict of interest. Regulation (EU) 600/2012 (accreditation and verification regulation for phase III) is explicit on this subject and the issue is a prime area of concern for national accreditation bodies to consider and address.

58

Directive 2003/87/EC and implementing measures do not define a requirement for on-the-spot inspections by the Competent Authorities. This retains flexibility for proportionate and efficient Competent Authority enforcement, including in relation to where and when inspections are most productive, avoidance of duplication of the verifier's role, and ability to combine with other regulatory duties.

64

The Commission agrees that regularly providing relevant information on the overall implementation and functioning of the EU ETS is beneficial to stakeholder confidence in the system. The reporting foreseen by Directive 2003/87/EC, in particular in accordance with its Articles 10 and 21, addresses this need.

67

In the context of the assessment of the NAPs of Member States, the PRIMES model, as a widely used analytical tool was considered to be the best-available reference. In particular, the model was known by Member States, considered reliable and used by some Member States themselves when preparing the NAPs.

The Commission acknowledges that the guidance issued in December 2005 did not include an instruction to use 2005 emissions data. However, the 2005 verified emissions were available to Member States since spring 2006 and thus well before the deadline for submitting the NAPs and well before most the NAPs were then submitted in practice. Taking into account the objective of the EU ETS, the Commission had to assess the NAPs against the most up-to-date emissions data which was also underlined by the Climate Change Committee.

69

The Commission acknowledges that it could not submit completed checklists for all Member States to the Court. The administrative retention period for such documents has expired. However, a number of other documents have been provided to the Court, such as correspondence with the Member States, presentations and briefing sheets.

Nevertheless, the Commission believes that there are no reasons to believe that the assessment of the NAPs was in any way not equally detailed or incomplete.

In particular, all publicly available Commission Decisions on Member States' NAPs have the same structure and provide an extensive justification of the reasons underpinning either the approval or the rejection of the NAPs in the recitals. For each aspect that should have been scrutinised by the Commission in accordance with Annex III of the directive, it is set out in detail whether the legal requirements have been complied with or not. They thus demonstrate that the Commission has carried out the assessment in the way mandated by Directive 2003/87/EC for all Member States in the same way.

Common reply to paragraphs 71 and 72

The Commission recognises that 'Article 21' reporting concerning EU ETS implementation was not always complete in phase II. Requirements are now being more rigorously implemented for phase III based on Commission Implementing Decision 2014/166/EU, so that the condition for the publication of a complete annual implementation report should be fulfilled in the future.

74

The Commission has further harmonised the implementation of EU ETS in phase III (therefore the revised EU ETS was adopted in 2009) and continues to consider options for possible further improvements in the future.

76

The legal framework leaves the performance of inspections up to Member States as part of their general approach to regulatory enforcement and in respect to the subsidiary principle the Commission has no specific role to play.

77
The Commission continues to organise extensive exchanges of information with the EU ETS competent authorities of the Member States such as by the regular deliberations of the Climate Change Committee and its Working Group 3 dedicated to Emissions Trading, ad hoc Technical Working Groups, forums such as the Accreditation and Verification Forum and the Compliance Forum with its associated Task Forces, and relevant groups such as the Registry Administrators' Working Group. Proceedings are usually shared electronically to assist those unable to attend meetings in person.

79
The Commission acknowledges the important additional role played by the EU ETS Compliance Forum and its task forces in harmonised implementation of EU ETS and the exchange of information on best practices between Member State competent authorities. Although attendance of national authorities was sometimes limited, the information discussed and developed in the Compliance Forum was shared through a web-based facility available to all Competent Authorities.

80
The high compliance rate is the best indicator of the deterrent effect of the EU ETS sanctioning regime, notably the EU-level penalty provision in the directive applicable in case of non-surrender of allowances.

Beside this EU-wide harmonised sanction, Member States determine and apply penalties to certain infringements, such as not submitting an emission report on time, on the basis of the relevant national legislation.

82
The Commission notes that variations with regard to the types of national infringements and penalties can be entirely justified taking into account national circumstances and administrative processes, all the more so when the co-legislators have decided to relegate the penalties under Article 16(1) of Directive 2003/87/EC to national competence under the principle of subsidiarity.

83
Overviews of the EU ETS sanctioning systems within Member States are being acquired as part of the Commission's Member State EU ETS compliance review studies and Commission Implementing Decision 2014/166/EU updating the system requiring Member States to submit annual 'Article 21' reports to the Commission on their implementation of the EU ETS directive.

84
The Commission does aim to maintain an EU ETS specific overview of national penalties and statistics on the application of penalties. It has already taken a more systematic approach of the monitoring of the sanctioning system, by improving the questions put to Member States on the penalties in the context of the report under Article 21 of Directive 2003/87/EC.

Member States authorities are responsible for the enforcement of the EU ETS provisions but the Commission follows closely the implementation of the EU ETS directive in the Member States. When, in phase II, there were doubts about the legality of the application of the penalties, the Commission always followed up on these and had regular contacts with Member States where necessary. For example, the Commission consistently recalled that Member States could not reduce the fines applied in cases of non-surrender of allowances of €100[14].

14 This interpretation of Article 16 has in the meantime been confirmed by the European Court of Justice.

86
In phase III of the EU ETS, operators can no longer use international credits directly to comply with their EU ETS obligations. Operators must first exchange their international credits for allowances which they can then use for compliance.

The number of international credits that an operator can exchange is limited. The rules for determining individual credit entitlements per installation and aircraft operator are set out in the Commission's Regulation (EU) 1123/2013. Operators receive an entitlement for the period 2008–20, therefore their entitlement for phase III takes account of what they benefitted in phase II.

Box 8 - Reply to second paragraph
In phase III of the EU ETS, similar problems should not occur anymore. Please see Commission reply to paragraph 86.

Box 8 - Reply to third paragraph
In phase III of the EU ETS, similar problems should not occur anymore. Please see Commission reply to paragraph 86.

Conclusions and recommendations

87
At the time of introduction of the ETS, no practical experience existed at national or EU level. Hence, the Commission and Member States pursued a learning-by-doing approach that has led to steady improvements both in design and implementation.

With regard to EU ETS and VAT carousel frauds, in order to address VAT frauds, the Commission provided a legal basis for Eurofisc, a network for the swift exchange of targeted information on fraudulent VAT transactions. Within this context the Member States also look at new fraud trends and provide early warning to each other if new frauds emerge. The carbon emission trade is one of the sectors that is under close monitoring by Member States in this context.

89
The Commission takes note of the Court's conclusion.

The Commission stresses that in phase II the EU ETS was hindered by some issues relating to the robustness of the framework for protecting its integrity. The fact that there were weaknesses in the implementation of the EU ETS in phase II is one of the important reasons for the careful consideration given to the new developments and improvements now being implemented in phase III.

91
Regarding the Court's findings that there are remaining issues in regulation and oversight of the emission market related to compliance traders, bilateral OTC spot trading and smaller market participants, the Commission and the co-legislators thoroughly analysed potential risks during the adoption process for MiFID, which contains therefore a well-balanced regime for exemptions. The supervisory framework established by EU financial markets legislation, which is also used for all commodity derivatives traded in the EU (e.g. MiFID position reporting, MAR sets out far reaching cooperation mechanisms) applies to the emissions market. The regulatory cooperation mechanisms will come into full force and effect as of 2017.

Recommendation 1
The Commission agrees that any significant remaining issues in emission market regulation and oversight should be addressed where necessary in order to improve market integrity. To ensure that EU action is required and effective, the Commission assesses the impact of its policies and proposals at every stage, from proposal to implementation and to review.

An evaluation of the recently adopted rules on emission market regulation and oversight, which are currently being implemented, may take place in the context of the reports to be submitted by the Commission to the European Parliament and the Council in 2019 under Article 90 of MiFID II and Article 38 of MAR.

Recommendation 1 (a)

The Commission accepts recommendation 1(a). The Commission and the co-legislators thoroughly analysed potential risks during the adoption process for the revised MiFID, which contains therefore a well-balanced regime for exemptions. They will be subject to review in 2019 under the relevant legislation.

The exemptions mentioned in Articles 2(1)(e), 2(1)(j) and Article 3(1)(e) of MiFID are subject to conditions and regulatory oversight and, they are not necessarily specific to emission allowances but apply equally to commodity derivatives. The reasons for the exemptions result from an assessment of the purpose of requiring a MiFID authorisation, (principally to protect clients of investment firms in cross-border transactions) as well as their proportionality with regards to the costs of obtaining such authorisation versus its benefits for the exempted persons.

Recommendation 1 (b)

The Commission accepts recommendation 1(b), as this takes into account the body of EU financial markets legislation which has been adopted and is currently being implemented.

Recommendation 1 (c)

The Commission partly accepts the recommendation 1(c). There are cooperation mechanisms in place, which the Commission considers adequate for the existing state of the emissions market. Commission services are present in the European Securities Markets Agency (ESMA) board/standing committees and working groups when policy issues are discussed and are in contact with the Agency for the Cooperation of Energy Regulators (ACER). However, the cooperation within the Commission is being further strengthened in the phase of implementation of the revised legislation. Concerning other regulators and supervising authorities (including agencies) and in the light of future market developments, the Commission will consider options for promoting initiatives to strengthen further the regulatory cooperation beyond those mechanisms already in place.

Recommendation 2

The Commission accepts recommendation 2. It will analyse the benefits of clarifying the legal status of allowances and will also consider whether and how an express registration mechanism for security interests could be provided.

The EU carbon market has grown and matured, despite the fact that the legal status of allowances is not defined at EU level. The factors driving liquidity are largely economic rather than legal in nature.

Hence, the Commission has already proposed to establish a market stability reserve (COM(2014)20) to address surplus allowances and improve the system's resilience to major shocks by adjusting the supply of allowances to be auctioned, which is being discussed by the European Parliament and the Council.

The Commission believes that Directive 2003/87/EC and Regulation (EU) 389/2013, as well as the evolving framework for EU financial markets regulation provide the necessary legal underpinnings for a transparent and liquid EU carbon market whilst ensuring the market's stability and integrity.

93

The security of the registry has been significantly improved over phase III of the EU ETS. In addition to enforcing the regulatory requirements for opening accounts, the Commission promotes active cooperation and exchange of best practices between Member States. Since 2012, the continuous improvement of the Union Registry in accordance with the relevant project methodology required adjustments within the Commission.

Recommendation 3 (a)
The Commission accepts recommendation 3(a). The Union Registry does not hold all the relevant data for detecting abuse and fraudulent activities. However, under MiFID/MiFIR and MAR/MAD, a significant data gathering exercise is already foreseen in relation to the financial side of transactions in allowances once these will have been fully implemented in 2017.

Recommendation 3 (b)
The Commission accepts recommendation 3(b).

Recommendation 3 (c)
The Commission accepts the recommendation 3(c). As regards the structure, the Commission considers that it has already been implemented. Following an IT audit by its Internal Audit Service, the Commission has further clarified the roles of the staff members and optimised the structure. The Commission is committed to ensure the good functioning of the registry system.

Recommendation 3 (d)–(e)
These recommendations are addressed to the Member States.

94
Commission regulations adopted before the start of phase III improve the effectiveness, efficiency and harmonisation of EU ETS implementation in phase III. These regulations address the weaknesses described by the Court. Improvements relate to monitoring and reporting and verification and accreditation, confirming the roles and responsibilities of all parties including competent authorities, operators, verifiers, national accreditation bodies and Member States.

Recommendation 4
The specific roles and responsibilities of all parties involved in EU ETS are clarified as the result of the Commission regulations on accreditation and verification and monitoring and reporting adopted for phase III.

Recommendation 4 (a)
The Commission accepts recommendation 4(a).

Recommendation 4 (b)
The Commission accepts recommendation 4(b). Directive 2003/87/EC and implementing measures define the framework for enforcement. This approach retains flexibility for proportionate and efficient Competent Authority enforcement, including in relation to where and when inspections are most productive, avoidance of duplication of the verifier's role, and ability to combine with other regulatory duties.

Recommendation 4 (c)–(f)
These recommendations are addressed to the Member States.

95
The Commission provided comprehensive guidance in the preparation and implementation of the NAPs for phase II. It acknowledges that this guidance did not include an instruction to use 2005 emissions data, which, however, has not affected the quality of the Commission's assessment.

The Commission's guidance and monitoring of Member States' implementation of EU ETS is improved in phase III. Commission Implementing Decision 2014/166/EU and an associated explanatory note have relaunched the system requiring Member States to submit annual 'Article 21' reports to the Commission on their implementation of Directive 2003/87/EC. These reports are publicly available via the European Environment Agency's ReportNet system.

96
The Commission recognises that 'Article 21' reporting concerning EU ETS implementation was not always complete in phase II. Requirements are now being more rigorously implemented for phase III based on Commission Implementing Decision 2014/166/EU, so that the condition for the publication of a complete annual implementation report should be fulfilled in the future.

The Commission continues to organise extensive exchanges of information with the Member States' EU ETS competent authorities such as by the regular deliberations of the Climate Change Committee and its Working Group 3 dedicated to Emissions Trading, ad hoc Technical Working Groups, forums such as the Accreditation and Verification Forum and the Compliance Forum with its associated Task Forces, and relevant groups such as the Registry Administrators' Working Group, and by associated document-sharing facilities.

Recommendation 5 (a)

The Commission accepts recommendation 5(a).

The harmonisation of EU ETS is substantial in phase III and the Commission is pursuing the monitoring of Member State implementation of the EU ETS more rigorously in phase III.

Recommendation 5 (b)

The Commission accepts recommendation 5(b) regarding regular publication of a report on the implementation of the EU ETS.

Recommendation 5 (c)

This recommendation is addressed to the Member States.

97
Overviews of the EU ETS sanctioning systems within Member States are being acquired as part of the Commission's Member State EU ETS compliance review studies and Commission Implementing Decision 2014/166/EU updating the system requiring Member States to submit annual 'Article 21' reports to the Commission on their implementation of Directive 2003/87/EC.

Recommendation 6

The Commission considers the EU ETS sanctioning system effective. The penalty of €100 per tonne of CO_2 emitted for which no allowances are surrendered by 30 April has a strong deterrent effect. This is in particular demonstrated by the fact that each year around 99 % of the emissions are actually covered by the required number of allowances and the penalty therefore only applies to 1 % of the emissions reported.

Member States should be transparent on the sanctions that apply at the national level for infringements other than the surrender obligation and should also publish the information on operators in breach of the surrender obligation. It is, however, important to note that according to Article 16(1) of Directive 2003/87/EC, Member States retain the right to determine sanctions and that variations between the level of the sanctions may well be justified taking into account the context in a given Member State.

The Commission attaches importance to transparency between Member States' Competent Authorities to maintain the very high compliance rate.

Recommendation 6 (a)

The Commission accepts recommendation 6(a).
It will analyse in detail the information it receives through the EU ETS compliance review studies and the annual reports submitted by the Member States pursuant to Article 21 of the EU ETS directive and take action where deemed appropriate.

Recommendation 6 (b)–(c)

These recommendations are addressed to the Member States.

HOW TO OBTAIN EU PUBLICATIONS

Free publications:

- one copy:
  via EU Bookshop (http://bookshop.europa.eu);
- more than one copy or posters/maps:
  from the European Union's representations (http://ec.europa.eu/represent_en.htm);
  from the delegations in non-EU countries (http://eeas.europa.eu/delegations/index_en.htm);
  by contacting the Europe Direct service (http://europa.eu/europedirect/index_en.htm) or
  calling 00 800 6 7 8 9 10 11 (freephone number from anywhere in the EU) (*).

  (*) The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

Priced publications:

- via EU Bookshop (http://bookshop.europa.eu).

The EU ETS is the cornerstone of the EU's climate policy and is often quoted as a model for emerging climate change policy in the world. The Court found significant weaknesses in implementation during phase II (2008–12) and problems with the robustness of the framework for protecting market integrity. Market regulation and oversight, the legal status of allowances, and systems for processing fundamental EU ETS information needed improvement. Member States should enhance their implementation of the control framework and sanctions. The Court makes a number of recommendations aimed at improving the integrity and implementation of the scheme.

CURIA RATIONUM
EUROPEAN COURT OF AUDITORS

Publications Office