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FIT FOR 55 AND ITS IMPACT ON THE CURRENT INDUSTRY STANDARD EU CARBON TRADING DOCUMENTATION

At a glance:

The changes introduced by the EU's 'Fit for 55' package will impact the industry standard EU allowances (**EUAs**) trading documentation. The legislative changes are significant and are likely to invite the question of whether an overhaul to of the current trading documentation is justified in light of that. The EU emissions trading scheme (**EU ETS**) has evolved over the years and the industry standard documentation, to track that, has been through incremental tweaks and adjustments along the way. However, the documentation is not easy to follow, has become clunky and reflects concepts and ideas from the early phases of the EU ETS that may not be applicable anymore. At the very least, the legislative changes provide an opportunity to ask the question: are the industry standard emissions trading documents currently both 'Fit for 55' and fit for purpose?

"The EU's 'Fit for 55' package is a series of legislative amendments to the laws governing the EU ETS intended to deliver the bloc's aim to reduce net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels."

Introduction:

Each of the three main industry bodies have their own trading documentation for over-the-counter (**OTC**) spot and derivative transactions in EUAs under the EU ETS. Each of the International Swaps and Derivatives Association (**ISDA**), the European Federation of Energy Traders (**EFET**) and the International Emissions Trading Association (**IETA**) either use an annex to their existing form of trading master agreement (ISDA and EFET) or have their own stand-alone master agreement for trading EUAs (IETA).

Following a harmonisation exercise carried out in 2006, the terms of each of the ISDA, EFET and IETA emissions trading documentation have broadly been consistent with each other, thereby allowing market participants to purchase under one set of OTC terms and onward sell under another set of OTC terms without having to worry too much about trading problems arising through documentation basis risk (for example, the differential treatment of suspension events or force majeure).

As the EU ETS moved through its various phases (we are currently in Phase 4), a conscious effort by the three industry bodies was undertaken to ensure that any updates to their respective documentation were always broadly consistent with each other. Now, with the introduction by the EU of significant changes to the EU ETS to accommodate the EU's Paris Agreement net zero objectives through its 'Fit for 55' legislative amendments, it is necessary to revisit the industry trading documentation to address the impact of these changes. Further, besides the Fit for 55 specific amendments, there have been a number of incremental changes to the EU ETS, such as its linkage with the Swiss Emissions Trading System (**Swiss ETS**) and removal of the limitations on compliance use of aviation allowances (**AEUAs**) as distinct from EUAs, which are not reflected in the current industry documentation.

Why does the 'Fit for 55' legislative package impact trading documentation?

The EU's 'Fit for 55' package is a series of legislative amendments to the laws governing the EU ETS intended to deliver the bloc's aim to reduce net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels. To achieve this, a number of significant amendments to the EU ETS legislation were proposed by the EU Commission and, following intense debate and negotiation between the EU Parliament and the EU Council, the amendments were finally agreed on 25 April 2023. The amendments, set out across different EU directives and regulations, became law on 5 June 2023. More subsidiary legislation (for example amendments to the Registries Regulation[1]) will follow.

Describing the 'Fit for 55' amendments are outside the scope of this briefing. That said, the following amendments are highlighted for their impact on how EUA trading is likely to be impacted and therefore, their potential consequential impact on EUA trading documentation.

1. The compliance deadline, for surrender of EUAs by compliance entities, has moved from 30 April to 30 September, starting from 2024.
2. The deadline for the distribution by Member States of the free allocation of EUAs will shift from 28 February to 30 June from 2024.
3. Carbon dioxide emissions from inter-EU and intra-EU shipping, as a new sector, will be brought within the scope of the EU ETS from 1 January 2024. Unlike previous sectors that have been newly introduced, shipping will not benefit from any free allocation of EUAs. Further, unlike when aviation was introduced into the EU ETS in 2012, shipping will not have its own form of shipping allowances and will use EUAs like other compliance entities within the EU ETS.
4. For aviation, there will be a gradual phase out of free allocation in 2024 and 2025 and full auctioning for aviation sector entities from 2026.
5. Overall, with the introduction of the carbon border adjustment mechanism (**CBAM**), carbon leakage in the EU will no longer be addressed by free allocation

1 Commission Delegated Regulation (EU) 2019/1122 of 12 March 2019 supplementing Directive 2003/87/EC of the European Parliament and of the Council as regards the functioning of the Union Registry (**Registries Regulation**)

of EUAs to sectors at risk of carbon leakage. Instead, there will be a gradual withdrawal of free allocation and an increase in the availability of EUAs through auctioning. Combined with an increase in the speed at which the EU ETS cap is going to be reduced to meet the higher ambitions under the 'Fit for 55' revised EU ETS targets, (i.e. through the increase in the linear reduction factor from an annual 2.2% reduction to 5.1% after 2024 and 5.38% from 2028), the simple outcome is that fewer EUAs will be available in the market over time.

What does that mean for how the market trades and what will be the consequential impact on trading documentation?

Many of the features of the EU ETS trading market that determined how market participants traded during Phase 1 to Phase 3 of the EU ETS and which accordingly determined how the EU ETS documentation should reflect that, potentially no longer apply in Phase 4 as a result of the 'Fit for 55' changes. The following is not an exhaustive list of amendments that may be considered for the EU ETS industry documentation, but is intended to stimulate discussion and complement the list of changes to documentation previously highlighted in respect of Swiss ETS linkage.[2]

Impact of increased scarcity of EUAs

The current documentation reflects a payment cycle where delivery of EUAs occurs first and an invoice is raised for delivered EUAs second. The payment window stated in the standard documentation is either (a) 5 business days following the later of the delivery date and the date on which the relevant VAT invoice is delivered to the buyer or (b) the later of (i) the twentieth day of the month following the end of the month in which the delivery date occurs, or if such day is not a business day, the first following day that is a business day; and (ii) the fifth business day following the date on which the relevant VAT invoice is delivered to the buyer. However, EUA prices in the last two years have moved from approximately €25 to in excess of €85, with EUA prices briefly crossing the €100 mark in February 2023. With the significant reduction in free allocation of EUAs and the increase in the linear reduction factor, it is unlikely that EUA prices will drop back to the 2021 prices. Therefore, payment cycles that permit settlement for delivered EUAs of 30 days would be unthinkable - even 5 days seems long. Typically, we have seen counterparties seeking same day or next day payments. The industry bodies may wish their documentation to reflect this new pricing reality to reduce the credit risk of the delivering party.

Impact of 30 September compliance deadline on the Long Stop Date following a Suspension Event

The industry documentation distinguishes between a force majeure and a suspension event. In the case of the ISDA documentation, it distinguishes between force majeure, settlement disruption events and suspension events.

Suspension events are typically limited to delivery problems triggered by issues with the underlying EUA delivery infrastructure (i.e. the Union Registry and the European Union Transaction Log). The suspension event concept was developed in response to prior experience of registry infrastructure issues that often took a much longer period to remedy than would be permitted if the event was considered a force majeure. However, rather than allowing an indefinite period of suspension, a 'Long Stop Date' was developed to ensure that there was a cut-off point following which the parties could walk-away from the transaction. Under the industry documentation, these dates were commonly agreed to ensure that any suspension period for the transaction obligations would not exceed 42 months. For example, for a suspension event occurring on 1 January 2023, if the issue was not resolved by 31 May 2026, 1 June 2026 would be the Long Stop Date, when the transaction would be terminated. Similar 1 June Long Stop Dates would occur throughout Phase 4 with the exception of the last year of Phase 4 when the Long Stop Date would be on 25 April 2031.

The principal logic driving this was that, if registry infrastructure issues occurred in the Union Registry, then the likelihood was that this was a market-wide problem (as opposed to it being counterparty account specific). Therefore, rather than allowing parties to freely walk-away from a transaction, however long the issue with the registry was, the transaction should not terminate prematurely. The exception to this was when the suspension period would carry over the last compliance deadline of a phase (i.e. the 'End of Phase Reconciliation Deadline') because EUAs issued prior to 1 January 2013 could not be automatically banked or carried over. Of course, EUAs issued after 1 January 2013 no longer have a 'Phase-related' expiry date. So, is the justification for the End of Phase Reconciliation Deadline still applicable?

The length of this suspension period was contemplated at a time when EUA supply was not anywhere near as constrained as it is anticipated to be in future years, due to the linear reduction factor. Further the original timing on the Long Stop Date, in the middle of a calendar year, was settled upon because it was an innocuous date. It was after the date for free allocation (i.e. the receipt of new supply) and the compliance deadline (i.e. surrender/use of the EUAs) and therefore, not influenced by these major annual market events. This date would therefore minimise the risk of abuse. However, with the change in the free allocation being moved back by four months (i.e. from 28 February to 30 June) and the compliance deadline being moved back by five months (i.e. from 30 April to 30 September), the 1 June date is no longer innocuous. So, applying the previous logic, should the Long Stop Dates now be moved back by five months or should the length of the suspension periods be revisited in their entirety?

How many 'Allowance Types' do the emissions trading documentation now need?

The concept of the Allowance Type, as originally envisioned in the earlier versions was to recognise that in the EU ETS, there were multiple type of

2 https://www.hfw.com/The-ISDA-EU-ETS-Annex-and-its-use-with-Article-25-linked-ETS-systems

acceptable compliance units: EUAs for stationary installations, AEUAs for aircraft operators and Kyoto Protocol units, in the form of Certified Emission Reductions (**CERs**) and Emission Reduction Units (**ERUs**). The use of CERs and ERUs ended at Phase 3 and in 2017, the EU removed the restriction that meant that only aircraft operators could use AEUAs for compliance use. Between 2013 and 2023, the allocation of AEUAs was scaled down – in line with the temporary reduction of the scope of EU ETS for aviation. From 2021 onwards, a linear reduction factor of 2.2% has been applied to allocation of AEUAs to aircraft operators. Free allocation of AEUAs will be completely phased out from 1 January 2026 onwards and those allowances will instead be auctioned.[3] As a result, eventually towards the end of Phase 4 the main compliance unit will be the EUA and, to the extent they have not yet been surrendered, any legacy AEUAs. With the inclusion of the shipping sector leading to an increase of available EUAs to extend the EU ETS cap, it appears that the EUA is intended to be the only compliance unit in the EU ETS going forward. However, with linked systems like the Swiss ETS benefitting from mutual recognition arrangements, there is a second currency that can be used within the EU ETS, a Swiss Emission Allowance (**CHU**). If, in the future, the UK Emissions Trading Scheme is also linked to the EU ETS, UK Allowances (**UKAs**) will similarly be a compliance unit for EU ETS purposes. Therefore, notwithstanding the EU ETS moving towards a single unit of compliance, it seems sensible to retain the concept of the 'Allowance Type' in the industry documentation even if the mix of Allowance Types needs to be revisited.

Multicurrency Transactions

The ISDA master agreement is a multicurrency agreement in that it doesn't matter what in currency the underlying transaction is entered into, upon a close out, the marked to market value of the closed-out transaction is converted into a common termination currency for the purposes of determining the termination payment amount. The EFET similarly allows for transactions in other currencies to be converted into Euros for the purposes of determining the termination payment amount. The IETA EU ETS Emissions Trading Master Agreement (**ETMA**) is not a multicurrency document and only allows termination amounts to be determined in Euros. However, Swiss CHUs trade in Swiss Francs (**CHF**) and, should the UK ETS be linked in the future, UKAs will trade in Pounds Sterling. The allowance transaction confirmations for both the ISDA and EFET will need to acknowledge trades in CHF and the IETA ETMA will need to become a multicurrency master agreement to accommodate trades in CHUs. With the potential for different 'Allowance Types' trading in different currencies, the industry bodies may wish to confirm with the market that they wish to retain the status quo whereby physical transaction netting only takes place between the same Allowance Types and in the same currency (i.e. therefore, you cannot physically net off a CHU against an EUA).

Excess Emissions Penalties (EEP)

This is a proverbial 'can of worms' that market participants will be reluctant to reopen. During the harmonisation process of the industry documentation in 2006, this provision was highly contentious. The EEP is the Euro 100 / tonne (linked to inflation) that is payable in circumstances where a compliance entity failed to surrender sufficient EUAs equal to its verified emissions together with the obligation to make up any shortfall in EUAs at the next compliance deadline. The Swiss ETS has a CHF 125 equivalent penalty.

The penalty only applies to a compliance entity and not to other market participants. Therefore, if a non-compliance entity (such as an intermediary) were to fail to deliver EUAs to a compliance entity leading to that compliance entity being unable to meet its EU ETS surrender requirements, the idea of the EEP was to allow the compliance entity to claim that loss from the intermediary who failed to deliver who, in turn, could then pass it up the chain to the entity that failed to deliver it to them. However, rather than make this an indemnity which is difficult for any organisation to offer, the EEP amount was a loss amount which could only be claimed if a number of requirements, including evidentiary requirements, could first be satisfied and no other mitigation of loss was possible. Each set of industry documentation addressed these requirements slightly differently, with EFET and IETA's documentation being similar and ISDA's creating two different electives.

However, with the EU ETS being oversupplied for most of its history, in practice a situation did not occur where there was a need to claim EEP because an abundance of EUAs could easily be purchased in the market. Besides, with the market's increased reliance on the EUA futures markets to guarantee delivery of EUAs both as a hedge as well as a source of supply, the concern about failed deliveries reduced. Notably, the EUA futures contracts do not include an EEP concept. Therefore, for the most part, parties elected for EEP not to apply between themselves. It could be argued that the need for an EEP clause in the industry documentation was almost redundant.

However, as one of the impacts of the 'Fit for 55' changes will be to decrease the available supply of EUAs over time as well as to reduce free allocation, it is conceivable that EEPs may become more likely. If this is correct, then the risk of compliance entities needing to rely on EEP is going to increase. So, although it is currently unnecessary, the concept is not obsolete and could become more relevant as we move towards the end of Phase 4. However, given the complexity of the EEP provisions in the industry standard documentation, should they be retained, it may be worth considering if the original drafting, contemplated for Phase 2, still works well for Phase 4.

In addition, the inclusion of shipping in the EU ETS raises a question as to whether parties should be able to claim EEP on behalf of their affiliates, which may be the actual compliance entities under the EU ETS. It is common in the shipping sector for fleet ownership to be dispersed across a web of one-ship companies

3 See Directive (EU) 2023/958 of the European Parliament and of the Council of 10 May 2023 amending Directive 2003/87/EC as regards aviation's contribution to the Union's economy-wide emission reduction target and the appropriate implementation of a global market-based measure. Note that full auctioning of allowances for the aviation sector is subject to certain exceptions, which relate to (a) an incentive scheme for the use of sustainable fuels and (b) the EU's Innovation Fund.

and it may make sense for a single entity to coordinate the sourcing of EUAs for the whole fleet. However, under the current documentation, it is generally not possible for a single entity to claim EEP on behalf of affiliated compliance entities in the absence of a contract between that single entity and each affiliate which makes that single entity liable to compensate the affiliate for EEP.

The standard ISDA documentation also has a concept of an *"EEP Risk Period"*, which must be specified in each Confirmation if the parties elect for EEP to apply. The EEP Risk Period is a period of time within which the Delivery Date must fall in order for EEP to be recoverable. The parties may want to consider what would be an appropriate EEP Risk Period in light of the change in the compliance deadline and the growing scarcity of EUAs.

Complying with the bilateral transaction requirement

Since the last amendment to the Registries Regulation in 2021, all entities have an obligation to report if the transactions in EUAs were purely bilateral in that they involved only a buyer and a seller that were both non-financial entities. However, according to the European Securities and Markets Authority (**ESMA**), this requirement has not been complied with in nearly 46% of all transactions.[4] This requirement is not a contractual obligation currently reflected in any of the industry standard documentation.

The reason for the inclusion of this obligation is to enhance the transparency of OTC transactions carried out in the EU ETS. Under current reporting requirements, the same EUAs and related derivatives are reported differently under the Markets in Financial Instruments Regulation (**MiFIR**) and other applicable sectoral acts such as the European Markets and Infrastructure Regulation (**EMIR**). For example, EMIR does not require reporting of spot transactions but under MiFIR, some exchanges have been reporting transactions involving their spot products as derivatives. This makes it difficult for ESMA to assess the proportion of OTC transactions recorded in the Union Registry (to allow it to assess the scale of OTC trading in EUAs that is missing in MiFIR transaction data) and it lacks the ability to determine whether the OTC trades include intragroup account transfers. Given the directly applicable nature of the Registries Regulation, the bilateral transaction reporting requirement should be incorporated into the industry standard documentation.

Does the 'Fit for 55' package fundamentally change how the market will operate?

This is a hard question to answer. There are enough changes to require a lot of tweaks to existing market transaction structures. For example, once the compliance deadline moves from 30 April to 30 September, logically the December EUA futures contract should not remain as the most liquid EUA futures contract. If the liquidity moves to another quarterly futures contract, this could also impact the timing of the 'cash and carry' EUA lending structures that typically required repayment of loans on or around the settlement dates of the EUA futures contract.

We have not yet seen the market trade CHUs as an alternative compliance unit to EUAs. However, besides the lack of OTC documentation to support it, there is no reason for such trades not to take place. With the currency and price differences, CHU for EUAs swaps could allow for currency arbitrage trades.

However, when the impact of the 'Fit for 55' changes are combined together with the impact of the Article 25 linkages with other emission trading systems, the amendments to the industry documentation are likely to be substantial. This provides a potential opportunity for a long overdue overhaul of the industry documentation. The current documentation has, with various tweaks, lasted over 15 years. Perhaps an overhaul will be timely.

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4 https://www.esma.europa.eu/sites/default/files/library/esma70-445-38_final_report_on_emission_allowances_and_associated_derivatives.pdf.

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