TRANSPARENCY INTERNATIONAL
the global coalition against corruption

Liaison Office to the European Union
Rue Breydel 40,
1040 Brussels, Belgium
Phone: +32-(0)2-235 86 45
Email: bnorsworthy@transparency.org
Twitter: http://twitter.com/ti_eu
Website: http://www.transparencyinternational.eu

European Commission
Directorate-General Climate Action
Unit B.1 – Implementation of ETS
Avenue de Beaulieu, 24
B-1049 Bruxelles, Belgium

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Promoting Integrity in the EU Emissions Trading Scheme:

Transparency International Submission to DG Climate Action on the state of the European Carbon Market

Transparency International (TI) is the global civil society organisation leading the fight against corruption, representing a global movement of more than 100 National Chapters committed to a world free from corruption and fraud.

Research[1] undertaken by Transparency International has shown that corruption in carbon trading undermines the flow of international financing for climate mitigation, discourages international cooperation, and wastes tax payers' money. TI's contribution to the European Commission's consultation on the strengthening of the European Carbon Market is concerned specifically with how governance and anti-corruption safeguards can strengthen the operational effectiveness of the carbon market. As oversight and regulation find it difficult to play catch up and restore order after markets have collapsed and trust has evaporated, reform of the EU carbon market must limit the corruption and fraud which undermine the market's effectiveness at reducing emissions.

1) Option a: Increasing the EU reduction target to 30% in 2020

Setting an ambitious – low – emissions cap is a prerequisite for achieving real emissions reductions. An emissions cap set too high creates an abundance of permits and does not provide incentives for investments in low-carbon technologies. For some regulated industries, conforming to an emissions cap may be unwelcome; the regulated entities have incentives to lobby for a generous cap and influence the design of the scheme. Undue influence in this way can limit the effectiveness of the market.

Implementing a sufficiently ambitious and long-term cap is imperative to ensure the stability of the market, as a stable market carries a lower corruption risk. The early collection of data on the actual GHG emissions of regulated entities helps establish realistic caps, but these data also need to be accurate and verifiable and overseen by sufficient and accountable book keeping.

2) Option b: Retiring a number of allowances in phase 3

Without robust monitoring mechanisms in place, there is a risk that any retiring of allowances is subject to lobbying at the Commission level and in danger of political collusion. To ensure that the process of identifying which allowances are to be retired is properly insulated from political and business influence, the EU should make publicly available as much information as possible to improve accountability amongst stakeholders, indicating which allowances are to be retired, how they have been selected, and the quantities involved. Retired allowances must be properly tracked and registered to ensure that there is no chance that they are able to re-enter the carbon market.

[1] http://files.transparency.org/content/download/103/415/file/2011_GCRclimatechange_EN.pdf

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3) Option c: Early revision of the annual linear reduction factor
An objective linear reduction factor would signal the EU's commitment to a reliable reduction in emission allowances and gradual removal of the surplus. With the EU's experience with emissions data collection, this option appears to be one which can be fairly objectively implemented amongst the proposed options. As an early revision of the annual linear reduction factor would fluctuate with underlying emissions, this potentially carries a lower corruption risk.

4) Option d: Extension of the scope of the EU ETS to other sectors
There are a number of governance perspectives that should be considered if the carbon market is extended to other energy related CO2 emissions in sectors outside the current ETS.

Extension of the scope would increase the scope of Monitoring, Reporting and Verification (MRV) requirements, potentially beyond the point at which they are realistically feasible. Research commissioned by TI has found that MRV is one of the commonest corruption risks in carbon trading, with the need to demonstrate relationships between mitigation actions and emissions at risk of undue influence. Potential weaknesses in the MRV process itself can pose corruption and fraud risks. Transparent and accountable agencies must therefore be responsible for undertaking MRV procedures.

Those firms that monitor emissions and calculate baselines should be prohibited from marketing credits to avoid conflicts of interest. Such structural transparency offers important co-benefits – public participation in policy processes and better institutions for development that reinforce the durability of the reductions achieved and the sustainability of the market itself.

Private investors may face additional risks under sectoral approaches; the role for policy here is not to eliminate risk, but to create the appropriate incentives to ensure that private capital and insurance markets can manage and mitigate it.

The Commission has rightly identified the need for determining who would carry the obligation to report emissions and surrender allowances. This could be strengthened by collecting and verifying the underlying emissions data, and employing auditors to verify the findings, as these are processes which potentially open up increased opportunities for corruption and collusion.

5) Option e: Use access to international credits
The quantity limit of international credits has been a major driver for the build up of the current surplus, by the Commission's own estimates representing a very significant amount of the present estimated surplus.

As has already been observed in mitigation initiatives such as the UN Clean Development Mechanism (CDM), robust monitoring mechanisms have to be put in place in order to avoid the inappropriate validation of projects, the verification of fictitious projects, the integrity of projects, and the overestimation, double-counting or fraudulent trade of carbon credits. Current procedures do not do enough to verify the emission reductions of offsetting schemes and how offsetting in third countries translates into real reductions in emissions.

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The Commission should also ensure that any reforms to increase access to international credits tackle cases where companies using offsets have also been selling their (freely awarded) permits, buying CDM credits at a significantly lower price and pocketing the difference. Such cases damage the reputation of the ETS and have a negative impact on market stability and trader confidence.

6) Option f: Discretionary price management mechanisms

Whilst a carbon price floor may create more certainty about the minimum price, any implementation of a price management mechanism must be carefully insulated to ensure that industry does not collude to set an artificially low carbon price and game the market. The European Union must prioritise the appointment of an independent monitor to oversee the auctioning of carbon emissions permits in order to protect against fraud, the gaming of carbon prices, and other forms of market abuse.

TI is also concerned that any discretionary price-based mechanisms, such as a carbon price floor and a reserve, could be at risk of political influence and lobbying by business interests. The procedures for artificially managing the carbon price (i.e. not leaving it to the interplay of market supply and demand) would therefore have to be adequately insulated from political processes. Open access to information and independent regulatory boards can help ensure transparency and accountability around decision making, whilst the integrity capacity of personnel should also be ensured. The environmental impact in the case of allowances being withdrawn because prices are too low is also negligible.

Conclusions

If the ETS is to be an effective tool for reducing GHG emissions, risk of corruption and fraud must be minimal. Strong oversight will be important for whichever structural reform option is adopted. To minimise corruption risk and to promote market stability, attention must be paid to prevent market manipulation and fraud, and ensure that structural reform is undertaken with the highest standards of oversight, transparency and effective enforcement in place.

As well as positively impacting upon reduction of GHG emissions, failure to transparently manage carbon credits undermines public trust. Transparency International recommends that the Commission:

- is wary of options that may be susceptible to conflicts of interest and regulatory weaknesses, and does its utmost to limit the effects of these. Independent oversight bodies will be important, as will making public as much information as possible surrounding the decisions taken and the actors involved;

- ensures those institutions responsible for overseeing carbon markets and for implementing any structural reform options are independent and accountable. The Commission should make provisions for ensuring sufficiently rigorous oversight and enforce penalties for offenders;

- if adopting those structural reform options which artificially set the carbon price or change emissions quotas, ensures the design of these mechanisms are properly insulated from influence by political and commercial interests. This is particularly important as corruption and fraud risks in cap and trade systems involve information asymmetries surrounding the setting of appropriate

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emissions quotas for each regulated firm. The Commission should also be wary of misrepresentation of information about emissions and emission reductions in order to obtain beneficial subsidies or to avoid paying taxes.

Jana Mittermaier
Director

Benjamin Norsworthy
EU Policy Officer

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Liaison Office to the EU
Rue Breydel 40
1040 Brussels, (Belgium)
E: bnorsworthy@transparency.org
T: +32 (0)2 23 58 645
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