

THE ISDA EU ETS ANNEX AND ITS USE WITH ARTICLE 25 LINKED ETS SYSTEMS

In this paper we highlight some of the challenges of adopting the ISDA EU emissions trading documentation in its current template form, when dealing with emissions trading systems that have been linked to the EU ETS under Article 25 of the EU ETS Directive. We outline the key amendments for market participants to consider making to the template form.

Introduction

The International Swaps and Derivatives Association ("**ISDA**") has amended its template form of Part 7 to the ISDA Master Agreement Schedule, relating to EU emissions allowance transactions for Phase 4 delivery (the "**ISDA Part 7**") in 2021, to take into account the EU Emissions Trading Systems ("**EU ETS**") linkages with other non-member state emission trading systems via Article 25 of the EU ETS Directive¹ ("**Linking Agreements**"). Although there is potential for a future Linking Agreement between the EU and the United Kingdom², at present, the only Linking Agreement in force is the agreement between the emissions trading systems of Switzerland ("**Swiss ETS**") and the EU ETS (the "**Swiss-EU Linking Agreement**") which came into force on 1 January 2020.³

The Swiss-EU Linking Agreement does not translate into Switzerland's adoption of the EU ETS. Rather, its effect is such that Switzerland operates the Swiss ETS in parallel to the EU ETS, with each emission trading system ("**ETS**") having its own registry (i.e. the "**Swiss Registry**" for the Swiss ETS, and the "**Union Registry**" for the EU ETS). Fundamentally, the Swiss-EU Linking Agreement seeks to provide the mutual recognition of the respective compliance units – i.e. for EU allowances ("**EUAs**") to be used to meet compliance obligations under the Swiss ETS, and Swiss allowances ("**CHUs**") to be used to meet compliance obligations under the EU ETS. To facilitate this, the Union Registry has been linked to the Swiss Registry, such that CHUs and EUAs can be freely transferred between the linked ETS systems.

However, although the Swiss-EU Linking Agreement has been operational for two years, there appears to be a lack of use of CHUs within the EU ETS. Accordingly, we consider that there remains scope for further amendments to the ISDA Part 7 to cater to the Swiss-EU Linking Agreement, and to also make it more flexible for potential use when *other* Linking Agreements (e.g. with the UK) are completed. In particular, we observe that the ISDA Part 7 is not drafted specifically with the Swiss ETS in mind. The amendments made in 2021 are arguably not specific enough to recognise the nuanced consequences arising from linking to a specific system such as the Swiss ETS. For example, transfers of EUAs and CHUs between accounts in the Union Registry and Swiss Registry can presently only be made on Tuesdays and Thursdays provided those days are not also public holidays.

In this paper, we highlight the key amendments which market participants should consider making to the template Part 7 to accommodate such Linking Agreements.

For the avoidance of doubt, this paper does not address the numerous changes to the ISDA Part 7 that will be necessary in light of the finalised Fit for 55 package ("**Fit for 55**") being determined by the EU Council and the EU Parliament.⁴ The Fit for 55 is a set of amendments to existing EU legislation aimed at enabling the EU to meet its target of reducing carbon emissions by 55% by 2030.⁵ The legislative amendments to the EU ETS (the "**EU ETS**")

¹ Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a system for greenhouse gas emission allowance trading within the Union and amending Council Directive 96/81/EC, as amended from time to time.

² For instance, a group of more than 40 industry bodies signed a letter to the UK Prime Minister on 14 April 2021, urging the commencement of linkage negotiations as soon as possible. <https://www.iigcc.org/download/uk-eu-ets-linkage-joint-letter/?wpdmdl=4464&refresh=64491fa85f84b1682513832>.

³ https://ec.europa.eu/commission/presscorner/detail/en/ip_19_6708.

⁴ <https://www.consilium.europa.eu/en/press/press-releases/2023/04/25/fit-for-55-council-adopts-key-pieces-of-legislation-delivering-on-2030-climate-targets/>.

⁵ <https://www.consilium.europa.eu/en/policies/green-deal/fit-for-55-the-eu-plan-for-a-green-transition/>.

Amendment) await publication in the EU official journal before entering into force. When the EU ETS Amendment comes into force, in our view, the manner in which trading is conducted in the EU will have to be reviewed. Changes are inevitable and a clear knock-on effect will therefore be that the ISDA Part 7 will need further modification. Our suggestions on those modifications will be the subject of a future paper. However, that consequential update to the ISDA Part 7 may be an opportunity to also address the Linking Agreement issues that we highlight in this paper.

Our comments can be broadly divided into the following categories:

- The choice of generic provisions or linked system-specific provisions;
- The EU ETS centric nature of the ISDA Part 7;
- Multicurrency markets and extra-EU tax impact; and
- Rethinking the triggers for Suspension Events and Abandonment of Scheme.

Generic provisions or linked ETS specific provisions?

The first issue is whether the amendments to the ISDA Part 7 should be specifically tailored to the nuances of Linked Agreements (including the Swiss-EU Linking Agreement), or be more generic as it is currently drafted. The current ISDA Part 7 does not cater specifically for the Swiss-EU Linking Agreement. The CHU is a different unit from the EUA – distinct from the EU ETS linkage with Norway and Liechtenstein via the European Economic Area (EEA) arrangements, whereby EUAs are the unit of compliance traded by EEA country compliance entities. In circumstances where there are other Linking Agreements aside from just the Swiss-EU Linking Agreement (e.g. if the UK emissions trading scheme were to be linked to the EU ETS) the ISDA Part 7, in its current form, would not be able to distinguish between a purchase of a CHU from a UK allowance ("**UKA**").

Further, where there are unique differences between Linking Agreements, accommodating to such differences likely requires the ISDA Part 7 to include additional elections specific to the Allowance Type in question. For example, if CHUs can only be delivered two days a week but UKAs can be delivered any day, the transaction confirmation would need flexibility to accommodate that. Of course, until any additional Linking Agreement is put in place, such choices are academic.

Some clear manifestations of how the choice of specific as opposed to generic provisions play out in the drafting are as follows:

- Part 7(a) on Scope of Application of Part 7 presently refers to the "*Fourth Compliance Period*", which is the current compliance period of the EU ETS. A linked ETS may be in a different compliance period – for example, the Swiss ETS is currently in the third commitment period.⁶ We would recommend amendments which leave open the possibility of specifying a different compliance period in the relevant confirmation if the parties are trading allowances created under the linked ETS ("**Linked ETS Allowances**").
- Part 7(d)(vi) on Requirements under the Scheme (EU ETS), which imposes obligations on the parties to comply with requirements under the EU ETS to facilitate delivery, requires the parties to have holding accounts validly registered in accordance with the (EU) Registries Regulation (i.e. accounts in the Union Registry), without contemplating delivery from or to an account in the linked registry.

It is possible to draft the ISDA Part 7 in a manner that is generic to the relevant Linking Agreement or linked system, although there would need to be specific elective provisions or CHU-specific terms developed in the suite of trade confirmations that would apply where the traded Allowance Type was a CHU (see further below).

The current ISDA Part 7 is currently too EU ETS centric

The definitions used in the ISDA Part 7 are too EU-centric and do not adequately cater for Linking Agreements and/or the trading of Linked ETS Allowances. For instance:

- The definition of "*Allowance Type*" does not include Linked ETS Allowances and therefore does not accommodate the trading of Linked ETS Allowances.
- The definition of "*Appropriate Source*", which is relevant for provisions dealing with "*Affected Allowances*" (i.e. stolen allowances), only refers to competent authorities in the EU and does not accommodate any competent authorities in a linked ETS, who may have a role to play in a case of stolen allowances.
- The definition of "*EEP Amount*", which refers to the penalty imposed on a compliance entity under an ETS for failing to surrender sufficient allowances by the compliance deadline, only refers to penalties payable in accordance with the "*Scheme*" (i.e. the EU ETS). Of course, the definition of "*Scheme*" only refers to the EU ETS and does not include any other ETS which is subject to a Linking Agreement.

⁶ <https://www.emissionsregistry.admin.ch/crweb/public/reporting/cp/period.action?token=6P97QVCFG7MQWNGOCLYQL3ZWZ33G6EEY&accountTypeCode=AVIATION>.

- The definition of "*Relevant Authority*" only refers to authorities mentioned in the EU Registries Regulation⁷ and not to the equivalent administering authorities of the linked ETS.
- At Part 7(d)(i)(2) *Delivery*, subsection (A) provides that the discharge of a Delivering Party's obligation to deliver Allowances pursuant to an EU Emissions Allowance Transaction shall occur in accordance with the "*Scheme*" (i.e. the EU ETS). Delivery ought to be conducted in accordance with the linked ETS as well. The delivery mechanics under the Swiss ETS differ in important respects from those under the EU ETS. For example, the requirement for the Delivering Party to ensure that the Receiving Party's Specified Holding Accounts are nominated on the trusted account list fails to recognize that linked registries may not have the same functionality.

Multicurrency markets and extra-EU tax impact

Historically, the EU ETS has been a Euro market. Therefore, although the ISDA Master Agreement (to which the ISDA Part 7 is annex to its Schedule) is a multicurrency agreement, all the standard form trade confirmations for EUAs only contemplate transactions in Euros. CHUs trade in Swiss Francs and, if linked in the future, UKAs trade in Sterling. Therefore, the EUA trade confirmations will need to accommodate the possibility of trades in currencies other than Euros and the possibility of arbitrage trades between similar units for compliance that are in different currencies and are locally priced differently under their respective trading systems.

The difference between the EU Value Added Tax ("**VAT**") regime and the equivalent regime of the linked system would also need to be addressed in the ISDA Part 7. After the lessons of the VAT fraud scandals of 2009-10, the EU ETS has just about managed to harmonise its VAT position in respect of EUA transactions across member states but whether the same position will be negotiated under the relevant Linking Agreement remains to be considered. Since the ISDA Part 7 deals with the VAT obligations arising from EUA transactions, it will also need to accommodate the VAT or equivalent obligations arising from transactions involving CHUs and other similarly linked allowances.

Rethinking the triggers for Suspension Events and Abandonment of Scheme

The ISDA Part 7 distinguishes a Settlement Disruption Event from its Force Majeure provision at Section 5(b)(ii) of the ISDA Master Agreement because it was felt that events, akin to force majeure, involving emissions markets required a longer period for resolution than for the usual financial products traded under the ISDA Master Agreement. However, a special category of force majeure event was further established, i.e. the Suspension Event, to recognise issues specific to the delivery infrastructure associated with EUAs. The Suspension Event therefore allows for an even longer suspension period than allowed for a Settlement Disruption Event, to ensure the trades do not automatically terminate following an issue involving registries or their linkage. This concern has proven justified over the history of the EU ETS. For example, access to the member state registries were suspended for months at a time following the hacking of EUA accounts in 2010-11.

In the context of how the Suspension Event must now contemplate the Linking Agreements, we highlight some examples below. A Suspension Event can arise where a delivery is not possible under two groups of events:

- The first, is a group of events associated with registry operations. The definition of "*Registry Operation*" presently does not include the continued functioning of the "*LSTL*" (i.e. the link between the transaction logs of the Union (EU) Registry and the linked system registry) in respect of transfers of linked system allowances such as CHUs.
- The second, is a group of events associated with actions of the relevant administrator of the registry. The definition of "*Administrator Event*" presently does not acknowledge potential powers that may arise in the hands of the relevant administrators of the Linking Agreement (e.g. a joint committee of the EU and the linked system country) to determine whether operations of the linked registry should be suspended where the Linking Agreement is terminated or suspended.

The *Abandonment of Scheme (EU ETS)* provision in the ISDA Part 7 (at Part 7(d)(iv)) has always been an anomaly compared to the equivalent EUA trading documents published by other trade bodies such as the European Federation of Energy Traders (EFET) allowances appendix or the European Emission Trading System Master Agreement published by the International Emissions Trading Association (IETA). This provision deals with a situation where, prior to a delivery date under the transaction, the EU ETS is abandoned (i.e. discontinued). There is no provision equivalent to this in the EFET or IETA documentation. Given how the EU is using the Fit for 55 to reinforce its commitment to the use of the EU ETS as the main tool to deliver on its Paris Agreement objectives to 2030 and beyond, the existence of this provision, first introduced by ISDA prior to the EU ETS coming into force in 2003, seems worthy of abandonment.

However, if it is to be retained, it needs to be amended to contemplate the situation where the Linking Agreement, providing for mutual recognition of Linked ETS Allowances, is abandoned.

⁷ Commission Regulation (EU) No 389/2013 of 2 May 2013, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02013R0389-20210101>.

Conclusion

The ISDA Part 7 goes further than the current equivalent trading documentation for EFET and IETA in that it recognises that the EU ETS has Linking Agreements in place. However, as highlighted above, for it to work effectively with the Swiss ETS or future linked systems, it will need further enhancements.

The changes introduced to the EU ETS via the Fit for 55 will require significant modification of the trading documentation formulated by ISDA, EFET and IETA. The revisions to those documents for Fit for 55 purposes would provide industry bodies the opportunity to amend their respective industry documentation to enhance the trading of Linked ETS Allowances.

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