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December 23, 2004

Lisa Constable
EU Emissions Trading Scheme
Department for the Environment Food and Rural Affairs
3/E1 Ashdown House
123 Victoria St
London SW1E 6DE

Re: EU ETS Submission on Regulation Amendments (No. 2)

Dear Ms. Constable:

With respect to the EU ETS Submission on Regulation Amendments (No. 2), the International Swaps and Derivatives Association, Inc. would like to submit this comment letter. We have prepared the comment letter in the requested format.

ORGANISATION/COMPANY	International Swaps and Derivatives Association, Inc. ("ISDA")
Sector (if applicable)	ISDA publishes various documents to facilitate transactions in the privately negotiated derivatives markets. One of the most recently published ISDA documents is a form of confirmation for a physically-settled EU emissions allowance transaction. This document is intended to be used in conjunction with one of the forms of master agreement published by ISDA.
Contact details	
NAP ID	
Permit number	

New Entrant Reserve	
4A	Do you agree with the proposed new entrant reserve provisions? Please give reasons.
Response:	
Closure	
5A	Do you agree with the proposed amendments relating to the implementation of policy for the closure of installations? Please give reasons.
Response:	
5B	In particular, do you agree with the proposed definition of “temporary period”?
Response:	
EU Registries Regulation	
6A	Do you agree with the proposed amendments relating to the Registries Regulation? Please give reasons.
Response:	
6B	Do you agree with the proposal to allow operators to nominate an additional authorised representative?
Response:	
6C	Do you agree with the proposal to block transfers out of accounts where an operator has failed to surrender sufficient allowances?
Response:	
Temporary Exclusion	
8A	Do you agree with the proposed amendments dealing with applications for temporary exclusion from the EU ETS? Please give reasons.
Response:	
FEES	
9A	Do you agree with the proposed fee amendments?
Response:	
9B	In particular, do you agree with the proposed scope and level of fees? Please

give reasons.

Response:

Insolvency

10A Do you agree with the proposed insolvency provisions?

Response:

ISDA has the following comments on the proposed insolvency provisions:

1. Freezing of accounts

The current proposals provide that an operator that becomes bankrupt or goes into liquidation is prevented from making further transfers from its account (even in respect of contracts for the sale of allowances that have been entered into prior to the date of bankruptcy or liquidation but where the delivery obligation arises after this date) until the allowances covering its reportable emissions for that year up to the date of insolvency have been surrendered. In order to calculate exactly the number of allowances required to be surrendered, the operator (acting by its liquidator or trustee in bankruptcy) must ensure the preparation of a report verifying the reportable emissions to the date of insolvency "in accordance with the relevant monitoring and reporting conditions" of the operator's emissions permit. The verification process will presumably therefore need to be in compliance with the criteria set out in Annex 5 of the ETS Directive.

In recognition of the considerable time this may take, the draft Regulations rightly allow the operator 3 months in which to submit the report. ISDA considers that insolvent operators, holding allowances in excess of the number needed to cover their emissions for that year up to the date of insolvency, will have to wait a considerable period of time before they are able to deal with their 'surplus' allowances (or perform their delivery obligations under pre-insolvency contracts for sale). This may unnecessarily fetter a liquidator/operator and prejudice the creditors of the operator as well as others trading in the allowances market (including other operators) who expect such allowances to be available for trading. The delay before such allowances may re-enter the market may have a negative effect on the liquidity of the allowances market. This may also be unnecessary since, while an exact calculation of the insolvent operator's emissions may take some time to calculate, it should be possible to provide a verified *estimate* of emissions at an earlier date (possibly with a 5% excess built in to protect the Government's position).

ISDA therefore recommends that provision is made in the scheme for a two stage process of emissions reporting upon the relevant insolvency events, with a verified estimate first being provided to the Government, followed by the later report, specifying actual reportable emissions, still subject to the 3 month time limit. Following receipt of the verified estimate, insolvent operators with these 'surplus' allowances should have those allowances unfrozen. Operators with allowances less

than the estimate should continue to be prevented from trading.

In the case of a winding up of an operator by the court, there is no need to include any provisions in the Regulations regarding the freezing of the operator's account following the making of a winding up order as the insolvency legislation already invalidates dispositions of the operator's property made after the commencement of the winding up unless the court orders otherwise (section 127 of the Insolvency Act 1986). ISDA notes that the same provisions do not apply in the case of dispositions of property following the commencement of a voluntary winding up and queries why there should be different insolvency rules which relate to the allowances (compared with other property of the operator). In any event, if additional provisions are included in the Regulations regarding the freezing of the operator's account (following either a compulsory or a voluntary winding up), ISDA proposes that these provisions should be consistent with section 127 (to ensure consistency of treatment in respect of all the assets and contracts of an insolvent operator) and should allow the counterparty to any contract entered into before the insolvency event (but where delivery is not to be effected until after the insolvency event) to apply to the court to seek a ratification of the transaction, with the court's discretion being exercised on the same principles as would apply in the case of an application under section 127.

2. Definition of insolvency event.

The definition of insolvency event in Regulation 37C (11) includes (at (e)) "anything analogous to, or having a substantially similar effect to any of the circumstances specified in (a) to (d) in any other jurisdiction". The insolvency events described earlier in the definition correctly relate to the last step in the winding up/bankruptcy process (i.e. the winding up order or resolution rather than the initial filing for such a process) (but see below). ISDA is concerned that the analogous/ similar effect wording risks earlier events in other jurisdictions triggering the insolvency provisions of the scheme, and therefore suggests that wording to make clear that the last step in the insolvency process (i.e. the order of the court or resolution of the company commencing the insolvency proceedings rather than the earlier date of filing for insolvency proceedings), regardless of jurisdiction, is intended as the trigger under the Regulations. The "analogous proceeding" wording should also make it clear that such proceedings are limited to bankruptcy, liquidation or winding up proceedings and do not extend to rescue or reorganisation proceedings.

Sub-sections (i) and (iii) of Regulation 37C (11)(d) could include a shareholders' resolution or order in a members' voluntary liquidation. ISDA notes that, unlike the other events in the definition of "insolvency event", in a members' voluntary liquidation, the company is not insolvent following the resolution. ISDA therefore submits that these sub-sections should expressly exclude a winding-up resolution or order in the context of a members' voluntary liquidation from the definition of insolvency event.

3. Transfers on the day of insolvency

Trades in allowances may take place on the same day as an insolvency event occurs. ISDA believes it would be helpful if the Regulations made clear that where delivery of allowances under sale contracts takes place on the same day as an insolvency event occurs, the validity of such trades will not be affected by the freezing provisions, particularly in jurisdictions that may have a "zero hour" rule where the insolvency proceedings are deemed to commence at midnight on the day in question.

10B In particular, do you agree with the proposal to deal with insolvency situations by deeming allowances sufficient to cover the installation's reportable emissions as having been surrendered? Please give reasons.

Response:**4. Surrender provisions**

The draft amending Regulations propose that, where an insolvency event occurs, an operator shall be deemed to have requested the surrender of sufficient allowances from its account to cover reportable emissions from the installation for the year up to the insolvency event.

A. Lack of uniformity in insolvency rules

ISDA members rely on the ISDA master agreement framework to trade in a variety of products across many jurisdictions. In so doing, the members rely on a uniformity of insolvency analysis across those jurisdictions and the master agreement terms are tailored to promote the development of efficient markets in such products. The introduction of different insolvency rules in respect of a single product (in this case, emissions allowances) in a single jurisdiction will cause considerable disruption to the trading process. ISDA therefore requests that the insolvency provisions contained in the draft Regulations are drafted so as not to upset the existing analysis of insolvency rules which many have come to rely on and which underpins the current, well-functioning trading system.

B. Instability in the allowances market

ISDA shares the Government's concern to ensure the integrity of the UK emissions trading market is maintained. ISDA believes, however, that the proposed rules on insolvency could seriously compromise the Government's aims by removing demand for allowances from the market, thereby causing the market value to crash.

By way of example, an operator may sell all of its allowances at the beginning of a trading year in order to raise funds, with a view to buying the necessary allowances back at the end of the trading year. If the operator becomes bankrupt or goes into liquidation before it is able to purchase the allowances it needs then, under the current proposals, the liquidator has the option to buy the allowances in the market or pay the penalty. However, if the liquidator did not have funds available to buy further

allowances to meet the operator's shortfall, the liquidator would not be in a position to buy the allowances and, instead, the operator would be liable to pay the penalty.

The allowances that the market expected the operator to buy back in order to meet its surrender obligation would remain in the market, swelling the total allowances available for trading. Where an operator with a large surrender obligation is subject to an insolvency event, there may be a very significant increase in the number of allowances available for trading which may have the effect of swamping the market and reducing the allowance price to zero. In addition, the fact that no allowances were surrendered in respect of the emissions of the operator subject to the insolvency event will mean that emissions in excess of the total allocation under the National Allocation Plan (**NAP**) may be emitted by the sectors subject to the NAP, thus breaching the environmental integrity of the scheme. This appears to be an unintended side effect of the Government's proposals as currently drafted.

ISDA therefore submits that the rules relating to insolvency be amended to ensure that demand for such "shortfall" allowances is maintained. To this end, ISDA proposes that the Government should be required to purchase the amount of allowances required to make up the shortfall so that those allowances are effectively removed from the market as the "deemed surrender" proposals appear to intend. The Government could then seek to recover the purchase costs from the insolvent operator if the Regulations were to provide that the operator was to indemnify the Government in this regard. ISDA would expect that the Government would rank as an ordinary unsecured creditor in this regard.

Alternatively, the Government may wish to consider the possibility of removing an amount of allowances equal to the operator's shortfall from the New Entrant Reserve (**NER**). This would have the effect of reducing the amount of allowances available for auction which would, in turn, reduce the Government's revenue from this source. The Government would therefore have a choice either to reduce the amount of allowances auctioned or buy allowances on the open market (in each case equal to the insolvent operator's shortfall). In the former case, the Government would avoid the additional costs of transaction fees. Clearly if there were no surplus allowances available in the NER, the Government would have to buy sufficient allowances to cover the shortfall on the open market.

C. Loss of liquidity in allowances market

Allowances held by the insolvent operator may be the subject of certain contracts for sale or security may have been granted over those allowances. If the operator who is obligated to deliver allowances becomes insolvent, each counterparty to those transactions may have an equitable interest in the allowances it is owed, particularly if the contract is capable of specific performance and the holder of any security will also have a proprietary interest in the allowances to the extent of the secured liabilities. It is unclear how (if at all) the deemed surrender provisions are intended to affect third parties who have, or may have, equitable or proprietary interests in the allowances which are the subject of the surrender provisions and this needs to be clarified for the sake of the market and to avoid protracted litigation on these issues.

The deemed surrender provisions may have serious knock-on effects for these creditor operators who were reliant on the allowances and consequently are unable to meet their obligations under the scheme.

ISDA recognises that creditors of an insolvent party are often likely to receive less than they were entitled to under their contracts but considers that the effective removal of allowances by the Government from the insolvent operator will exacerbate the situation and may reduce the liquidity in the allowance trading market.

D. Possible breach of insolvency rules

ISDA also notes that the proposal in relation to the deemed surrender of allowances is out of line with recent moves by the Government to place itself on a level footing with other creditors under section 251 of the Enterprise Act 2002. Furthermore ISDA considers that the obligation placed on the operator to surrender its assets on insolvency may be in breach insolvency rules (see the case of *British Eagle International Airlines Limited v Compagnie Nationale Air France* [1975] 1 WLR 758)

E. Pari passu ranking

ISDA assumes that, in line with the changes in s.251 of the Enterprise Act 2002, the civil penalty referred to in Regulation 37C(3)(b) will rank as an ordinary unsecured claim against the operator, *pari passu* with its other ordinary unsecured creditors, and will not have preferential status in the bankruptcy or winding-up proceedings.

Other comments:

Please do not hesitate to contact Peter Werner (pwerner@isda.org) with any questions. Thank you for your consideration.

Sincerely,

Dr Peter M Werner
Policy Director, ISDA