

Fraud and scams in the EU Emissions Trading System

by Tamra Gilbertson
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As new cap and trade markets emerge on the global horizon, the world looks to the EU Emissions Trading System (ETS) for insight and lessons learned. This form of free-market environmentalism is presented as the 'only game in town' for those seeking action on climate change.

With a host of problems since the inception of the EU ETS six years ago, it is time to ask whether an emissions trading system is fundamentally flawed and, if so, what is to be expected if these costly mistakes are repeated on a larger scale?

The EU ETS is the largest existing carbon market in the world, valued at €88.7 billion in 2009.¹ The aim is to put a 'cap' on greenhouse gas emissions but evidence mounts against the scheme with many loopholes allowing for a carbon market with no real cap which awards profits to the biggest polluters.

The market consists of trading through spot, futures and options contracts, exchanging 6.3 billion tonnes of CO₂-e in 2009. It trades 'carbon permits' called European Union Allowances (EUAs), which are allocated according to National Allocation Plans, which are in turn subject to European Commission approval.

The EU ETS covers approximately 11,000 power stations, factories and refineries in 30 countries which include the 27 EU member states, plus Norway, Iceland and Lichtenstein. These account for almost half of the EU's CO₂ emissions, covering most of the largest static emissions sources, including power and heat generation, oil refineries, iron and steel, pulp and paper, cement, lime and glass production.

In the first phase of the scheme, from 2005~2007, emissions permits were over-allocated to these industries, largely as a result of intense corporate lobbying. When the first emissions data were released in April 2006, they showed that 4% more permits were handed out than the actual level of emissions within the EU. In other words, the 'cap' did not cap anything, nor was it just the first year of the scheme that was over-allocated. By the end of the first phase, emitters had been allowed to emit 130 million tonnes more CO₂ than they actually did before the scheme was established ~ a surplus of 2.1%. The price of carbon permits collapsed as a result and never recovered. From a peak of around €30, the price slid below €10 in April 2006, and below €1 in 2007.

A further major criticism leveled at the first phase of the EU ETS is that it generated huge profits for power producers, helping them to make large unearned financial gains as a result of flaws in the rules rather than any proactive measures taken to reduce emissions through structural changes. An inquiry by the UK Parliament's Environmental Audit Committee found that "it is widely accepted that UK power generators are likely to make substantial windfall profits from the EU ETS amounting to £500 million a year or more."²

These profits were mainly enjoyed by energy companies based on how they account for the costs of the EU ETS. The costs that are indirectly passed on to consumers through an increase in wholesale energy prices do not reflect what carbon credits actually cost, but rather what the companies assume they could cost. This leaves considerable scope for overestimates.

The same fundamental problems of over-allocated permits and windfall profits for polluters are occurring in the second phase of the EU scheme, which runs from 2008-2012. Research by market analysts Point Carbon, for example, has calculated that the likely profits made by power companies in phase two could be between €23 billion and €71 billion (and between €6 and €15 billion for UK power producers alone).

This is already storing up problems for the third phase of the EU ETS too. The main reason why the price of EUA permits in phase two has not collapsed to zero is that it is now possible to "bank" them – in other words, to hold onto surplus permits for use in the third phase of the scheme, which will run from 2013 to 2020.

Carbon offsets are another fundamental problem with carbon trading. The EU ETS is the biggest buyer of credits issued through the UN-backed Clean Development Mechanism (CDM). By using offsets to meet emissions reductions targets, the purpose of capping emissions becomes obsolete. Companies can simply buy credits to pollute from so-called emissions reduction projects in the South, thereby eliminating the need to reduce pollution at source and, as extensive research has shown, exacerbate social and environmental problems for communities in the South.³

Other forms of fraud

In addition to over-allocation, windfall profits and the more fundamental problems with the EU ETS, other scandals have taken centre stage recently. In 2010, reports of more sophisticated forms of corruption have demonstrated that when 'buying' and 'selling' a sham commodity, the possibilities for fraud are endless.

'Carousel fraud', which was widespread in 2010, involves claiming value-added tax (VAT) refunds from international carbon trades. The traders import the "goods" or allowances tax-free from markets in other countries and sell them on to domestic buyers, charging the VAT which was never passed on to the treasuries. The result is a quick and difficult-to-trace profit. Part of the problem is that trading in the ETS happens over several different registries making transactions and 'authentic' allowances difficult to verify. The European investigation continues, at the time of writing, with a suspected –5 billion carbon trading tax cost, across at least 11 countries.

New EU regulations have tightened up VAT regulation, making this form of fraud more difficult. However, registries are lax and inconsistent across EU states. When the allowances enter the registries, their authenticity is nearly impossible to determine.

More fundamentally, many registries neglect to carry out any checks on the applicants that seek to open a trading account. The Danish registry, for example, failed to administer checks over the course of two years and was found to be filled with fraudulent companies and false names. Over 90% of the account holders in the Danish system were deleted last year.

When recycling is bad

The CDM has also been subject to global scrutiny not only for its failure to reduce emissions but also the authenticity of projects based on additionality fraud. Within the CDM, credit recycling, also referred to as double counting, can occur in several ways. Until recently, it was largely seen within companies selling the same credits on both the voluntary and CDM markets. In other words, instead of expiring already 'used' credits, they were sold again but on another market.

In 2007, the chemical corporation Rhodia and cement company Lafarge were accused of using credits from the CDM to meet voluntary corporate targets and later sold them at a profit to be counted again elsewhere. The companies can use credits from the CDM to meet mandatory targets under the EU ETS and also use them to meet voluntary reductions elsewhere. In addition, other companies claim reductions as well.⁴

Last year, another type of credit recycling scandal broke. This time the recycling involved swapping allowances for credits – a legal loophole between the two markets. The Hungarian government swapped Assigned Amount Units (AAUs) for Certified Emission Reductions (CER) from the CDM which companies had already used under the EU ETS to cover

their emissions, then later sold the CERs on for more money. (AAUs are a tradeable carbon credit unit recognised within the Kyoto Protocol.)

Hungary has a surplus of AAUs due to its 'hot air' allowances which do not fetch a high price nor will they have worth post-2012. Hungary sold on two million retired offset credits knowing they would fetch a higher price than the AAUs.⁵ As a result, French and Nordic exchanges were forced to close trading when the offset credits (CERs) were found to be resold, forcing the spot price of the credits to collapse from €12 a tonne of carbon to less than €1.⁶

Offsets are rife with corruption from the ground up, from the projects to the companies that implement them all the way to double counting on the market. Offsets enable companies and governments in the North to continue polluting while exacerbating harmful development in the South.

Gone Phishing

Other fraud in the market includes the creation of fake registries. The wide-spread 'phishing attacks' were prompted by e-mails to thousands of firms around the globe, including New Zealand, Norway and Australia, with the hardest hit countries being Germany, Belgium, Denmark, Greece, Italy, the Netherlands and Spain. The attack closed down registries in at least 13 countries while fraudulent transactions were conducted.

The scam involved emails promoting the fake registry and prompted users to log on to their website and reveal user identification codes to carbon trading registries. The 'phishers' would then use this information to carry out transactions in the registries. It is estimated that over €3 million were netted in phishing scams in February 2010.⁷

Hacking on the 'Spot'

Possibly the most costly scandal has been hacking into computer systems and selling the allowances on the 'spot' market – the trade for permits in return for cash payments, which is estimated to account for 10–25% of the total market. Spot trading allows permits to be sold for cash. The spot market increased 450% over 2008 which totalled 1.4 billion tonnes in 2008. Spot volumes in the first half of 2009 increased 75-fold from 2008.⁸

Stolen permits from a Czech firm in January 2011 prompted spot trading to close for nearly two weeks. The hackers found a way to sell over €7 million in emissions permits from Blackstone Global Ventures.

In Greece, hackers got into the server system of the University of Patras, using it as a Trojan horse and then stole €4 million in credits from the cement company Halyps. Some of the hackers were based in Romania and were later prevented by authorities from selling up to €28 million worth of additional credits.⁹

In theory, there is as much control over selling a carbon permit for cash as for purchasing a shipment of coal. However, in the case of virtual goods like carbon permits, these are not mere 'permission slips' for polluters, rather, they represent money – traded and sold by banks and firms – which can be used to 'meet' emissions targets, banked for future use or sold on at a different price.

European countries have called for a central register to control the CO2 certificate trades earlier than the 2013 planned date. However, the proposed central registry would link to emerging markets in other OECD countries. The market is rife with loopholes and ways to sidestep responsibilities. Global linking would increase, rather than reduce, the complexity and potential for fraudulent trading, because it would involve exchanges of permits that are subjected to different financial and environmental rules.

Conclusion

The EU ETS is a concrete example on how the use of market-based solutions to address climate change is delaying real change towards a carbon-free future while allowing business as usual to continue. Trading a virtual commodity on a market is a dangerous and costly distraction from the real task of reducing greenhouse gas emissions at source and keeping fossil fuels in the ground. Expanding the market into a centrally traded registry is not going to eliminate fraud and hacking in the long term because the aim is to link to other global systems which could arguably lead to increased infiltration, and no computer system is unhackable.

Proponents claim the problems with the EU ETS are simply teething troubles and will be worked out in time. However, before these problems are addressed supporters continue to push ahead with plans for expansion on a global market, despite evidence that the EU ETS has not delivered. Perhaps the bigger scam is that the EU ETS has unequivocally failed to reduce emissions yet countries intend to replicate this failure.

Carbon trading systems are now seen as the 'only game in town', distracting from the hard truth that free-market environmentalism has not proven effective. Six years on, the EU ETS has not reduced emissions in the North or created real lasting changes to address the climate crisis.

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