

Meeting: International Public Sector Accounting
Standards Board

Meeting Location: Santiago, Chile

Meeting Date: March 10–13, 2015

Agenda Item 11

For:

Approval

Discussion

Information

Emissions Trading Schemes

Objectives of Agenda Item

1. The objective of this session is to provide direction on development of an Emissions Trading Schemes consultation paper.

Materials Presented

Agenda Item 11.1 Issues Paper

Actions Requested

2. The IPSASB is asked to discuss the issues identified and provide direction on development of an Emissions Trading Schemes consultation paper.

Objectives of this Paper

1. This paper identifies issues for development of the consultation paper (CP) on accounting for Emissions Trading Schemes (ETs). Staff seek direction from the IPSASB on these issues.

Background

2. After the project brief approval in December 2013 the ETS project was activated in September 2014. The Task Based Group for this project consists of Aracelly Mendez, Angela Ryan, Fabienne Colignon (CNOCP) and Martin Koehler (European Commission).
3. An education session on ETs was provided to the IPSASB at its December 2014 meeting. Staff described the project's context, recent ETS developments, and the ETS financial accounting practices that had been identified at that point in time, focusing mainly on "cap and trade" schemes. Ken Warren described the New Zealand Government's accounting for its ETS involvement. John Verrinder described the statistical community's development of a GFS reporting guideline termed a "split asset" approach. Staff noted that more information is needed on other financial reporting practices used by ETS administrators.
4. Phase 1 of this project—development of the CP—involves collaboration with IASB staff. Collaboration involves sharing information and ideas, which is expected to provide efficiency gains and support consistency for public sector/private sector financial reporting by ETS participants. The lead technical staff for the IASB ETS project is Ms. Jane Pike, Technical Principal. IASB staff stated, in a January IASB meeting paper, that:

Staff think that this collaborative approach will assist the IASB in identifying a more principle-based approach to the accounting for emissions management schemes. This will improve consistency in the accounting for such schemes and more faithfully represent their economic effect. [Paragraph 19, IASB Agenda ref 6.]
5. The IASB discussion paper will focus exclusively on financial reporting by ETS participants. The IPSASB consultation paper will address financial reporting by both ETS administrators and participants. Appendix A provides a summary of IASB meetings that have discussed the IASB's ETS project since the IASB ETS project was restarted in September 2014. The appendix includes links to the relevant IASB meeting papers.

Overview of Issues

6. This paper highlights four issues for the IPSASB's consideration. The issues are:
 - (a) Draft structure of the consultation paper;
 - (b) Project scope;
 - (c) Generic approach to accounting for different types of ETs; and
 - (d) Common ETS factors relevant to accounting approaches.

Issue 1: Draft Structure of the Consultation Paper

7. A proposed draft structure for the ETS CP is provided in Appendix B. The draft structure would act as a road map for developing the CP. As the project proceeds the structure may need to change.
8. The proposed structure is similar to that used in recent IPSASB consultation papers, particularly the draft CPs for Social Benefits and for Public Sector Specific Financial Instruments. Staff notes that the structures of these two draft CPs are still evolving. The draft CP structure also considers the possible impact of accounting issues specific to the ETS topic.
9. The draft structure proposes that the CP provide information on:
 - (a) The phenomenon (ETs) for which an IPSAS is proposed;
 - (b) Why the IPSASB considers that an IPSAS could be needed to address this phenomenon;
 - (c) The different financial reporting approaches considered by the IPSASB in order to identify the accounting approaches for consideration; and
 - (d) Evaluations of the different approaches.
10. Given the early stage of this project the draft structure has not identified financial reporting approaches (options) for consideration, and only indicates a number (three) to illustrate the idea that different options will be considered. As IPSASB members heard at the December meeting, at least two different approaches to administrator's financial reporting exist (split asset approach and financial asset approach). There are presently three or four different practices with respect to participants' ETS financial reporting; split asset approach applied to participants, and three other approaches applied by private sector participant entities—and at least some public sector participant entities—although there is sufficient common ground between the variations such that, arguably, the number of distinctly different approaches could be characterized as less than three.
11. The draft structure indicates that each approach could warrant a separate section. The ETS topic also raises the possibility of considering accounting treatments in terms of different perspectives (administrator versus participant) or different types of ETS (cap and trade versus baseline and credit). If these distinctions emerge as factors that drive identification and classification of accounting approaches then the CP's structure is likely to evolve so that it reflects the importance of these distinctions.

Action Requested:

1. Members are asked to provide direction on the proposed draft structure for the CP.

Issue 2: Project Scope

Administrators, Participants and Traders

12. The ETS project brief includes administrators and participants in the project scope, but “traders” are not mentioned. Traders are entities that purchase and sell emission allowances, without having any other involvement with an ETS. A controlling entity may include both controlled entities that are pure traders and those that do not trade but instead are only ETS participants. Some ETS participants also trade in emission allowances.
13. IFRIC 3, *Emission Rights*—now withdrawn—only applied to ETS participants. Its basis for conclusions noted that traders were not included within the IFRIC’s scope, but the reason for this exclusion was not provided. The IASB’s present ETS project will cover accounting by emitters, traders and entities that carry out projects to reduce or absorb emissions¹.
14. Staff proposes that traders should be included in the project’s scope. Appropriate accounting for emission allowances should generally be independent of the type of entity. If certain entities are excluded from coverage, there could be inconsistent treatment of the same underlying economic reality (emissions allowances and their equivalents) by different entities, reducing the comparability of reported financial information and its usefulness to the users of General Purpose Financial Reports (GPFs). However, it is not known whether any public sector entities are likely to be pure traders. Therefore, the project’s scope may not need to cover traders.

Different Roles: Administrators and Participants

15. Administrators and participants have different roles, different powers, and different aims with respect to their ETS involvement. This could impact on the accounting treatment they apply. While symmetry between an administrator’s issuing of emissions allowances and a participant’s receipt of allowances has been noted previously as a project consideration, it is not assumed. Each type of involvement will need to be analyzed separately and understood from the appropriate perspective. Therefore, the “entity-neutral” approach referred to above should not be interpreted as removing the need to consider transactions from both the administrator’s perspective and the participant’s perspective.

Types of Emission Trading Schemes—Generic Approach

16. The ETS project brief proposes that both cap-and-trade and baseline-and-credit ETSs should be addressed, and asks whether other types of ETSs should be addressed. The project brief identifies “command and control schemes” as another type of scheme.
17. Staff proposes that all types of ETSs should be considered by the project, using a generic approach which would attempt to identify the common, fundamental characteristics of ETSs for financial reporting purposes. In December, staff noted that ETSs continue to evolve over time as governments learn from their ETS experience. The apparently changing nature of ETSs makes it important to identify the fundamental factors that remain the same.
18. This approach would be consistent with that proposed for the IASB project:

¹ IASB agenda paper 6, January 2015.

14. The staff recommend that the research should focus on trying to identify common characteristics of a wide variety of schemes and the resultant overall economic effects of those characteristics. This should support the identification of a principle-based approach to accounting for identified schemes, which could be used as the basis for developing robust accounting policies for new and changing schemes. [Agenda paper 6, IASB meeting, January 2015]
19. In January 2015 the IASB indicated its support for this approach, recommended by IASB staff.

Command and Control Schemes

20. “Command and control” schemes consist of government regulation that directly addresses pollution, without the involvement of a market mechanism. For example, governments can pass legislation that requires coal powered electricity generators to install filters to reduce the amount of pollutants emitted, set limits on emissions and use fines to enforce the limits. Command and control does not involve issuance and trading of emission allowances or emission allowance equivalents. Descriptions of what is meant by “command and control” include:

Command and control policy refers to environmental policy that relies on regulation (permission, prohibition, standard setting and enforcement) as opposed to financial incentives, that is, economic instruments of cost internalization².

Command and control (CAC) regulation can be defined as “the direct regulation of an industry or activity by legislation that states what is permitted and what is illegal”. This approach differs from other regulatory techniques, e.g. the use of economic incentives, which frequently includes the use of taxes and subsidies as incentives for compliance. The ‘command’ is the presentation of quality standards/targets by a government authority that must be complied with. The ‘control’ part signifies the negative sanctions that may result from non-compliance e.g. prosecution³.

21. Staff proposes that command and control regulation should not be included in the project’s scope.

Other Emissions Reduction Mechanisms

22. Governments use other mechanisms to reduce emissions, instead of or in addition to ETs. Examples of such mechanisms include:
- (a) *Carbon taxes*, which place a price on carbon, using a metric based on carbon (e.g. price per metric ton of CO₂ or equivalent (tCO₂e)). A carbon tax guarantees the carbon price in the economic system and, if the price is high enough, will provide an incentive for entities to reduce their emissions to reduce the tax cost.
 - (b) *Results-based financing*, which uses a financing approach to support development objectives and policy goals. Financing approaches are used, for example, for reducing emissions from deforestation and forest degradation, and to support the role of conservation, sustainable management of forests and enhancement of forest carbon stocks. A variety of forms of results-based financing exist. In some cases, contributors of finance receive carbon credits or allowances in exchange. Such credits or allowances may be remitted to the administrator of

² Glossary of Environment Statistics, Studies in Methods, Series F, No. 67, United Nations, New York, 1997.

³ McManus, P. (2009) Environmental Regulation. Australia: Elsevier Ltd

an emissions trading scheme to which the contributor is a participant, instead of credits or allowances issued by that scheme.

23. Staff proposes that the project's focus be restricted to schemes that involve creation of tradable allowances and emission allowance equivalents. A broader focus on governments' regulation and policies could reduce the project's ability to effectively address the financial reporting problems that exist with respect to ETSSs. IPSASs already address some of the financial reporting issues raised by these other methods. For example, IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* addresses accounting for revenue received from taxes, including carbon taxes.

Wider Consideration of Emission Reduction Mechanisms

24. The proposed focus on schemes with tradable emission allowances would, however, include consideration of schemes (or "emission reduction mechanisms") that are not described as ETSSs, but which nevertheless create emission allowances or emission allowance equivalents. For example, the description above, in 22(b), of a "results-based financing approach" notes that contributors of finance may receive emission allowances in exchange for financing. Staff would review a wider set of government emissions reduction mechanisms to consider whether they include scope to create tradable emissions allowances or emission allowance equivalents. Such a review would also consider mixed approaches using several different regulatory tools, in order to understand their implications for ETS financial reporting. At least one country, for example, allows entities to choose whether to become an ETS participant or to simply pay carbon taxes.

"Emissions Trading Schemes", "Emissions Management Schemes" or "Pollutant Pricing Mechanisms"

25. In January 2015 the IASB decided to change the name of its ETS project to "Emissions Management Schemes". Subsequently the IASB's translation department identified translation difficulties arising from the term "emissions management". IASB technical staff have noted "pollutant pricing mechanisms" as a possible alternative project name. The IASB has not formally discussed this second possibility.
26. The IASB consideration of a new name does not appear to indicate a movement away from focusing on schemes involving trading. The name change was linked by the IASB to a broad focus, but one which has trading as a common feature, as evident from the staff recommendation:
- The staff recommend that the IASB set the scope of the project broadly to consider a variety of schemes that use emissions allowances to manage the emission of pollutants. This would encompass both cap and trade and baseline and credit emissions trading schemes, as well as schemes that involve the issue of tradable allowances that can be used to satisfy obligations in those schemes. It would also encompass the accounting for tradable allowances by participants (i.e. emitters that are required to remit allowances to the scheme administrator), traders in the allowances, and recipients who receive allowances in exchange for carrying out activities that either reduce emissions or absorb/sequester pollutants.
27. Staff recommend that the IPSASB project name remain unchanged, applying the same reasoning above to support a focus on creation of tradable emissions allowances. Pollutant pricing mechanisms appear broader than emissions trading schemes in two ways:
- (a) They address pollution generally (e.g. plastic bags, chemicals issued into water, gas emissions, etc.); and

- (b) “Pricing” describes mechanisms other than tradable allowances, including taxes on pollutants.

Environmental Reporting and Wider Set of ETS Impacts

- 28. Entities engage in many different activities to reduce their impact on the environment, including their “carbon footprint⁴”. For example an entity may have policies to restrict staff travel or restrict paper printing of papers and emails. Entities may also make public commitments to clean up polluted sites, with implications for their recognition of provisions. Environment-friendly activities may be reported on as part of an entity’s annual report or in a separate report about the entity’s environmental impact. Such reporting could include narrative discussion of environmentally friendly policies and their results, including measurement of carbon emissions or financial information about investments in pollution reduction technology. Staff recommends that reporting on this broad set of activities should be treated as outside of the ETS project’s scope.
- 29. An administrator’s service performance information on service performance objectives related to reduction of polluting emissions and ETS administration will be within the scope of the recommended practice guide (RPG) on reporting service performance information. An administrator’s involvement with ETSs may have financial impacts that are addressed by existing or planned IPSASs. For example, an ETS administrator may incur:
 - (a) ETS monitoring and enforcement costs; and
 - (b) Employee benefit obligations arising from staff administration of the ETS.
- 30. Similarly, there is a wider set of events with financial reporting consequences for ETS participants, which are within the scope of existing IPSASs. These include:
 - (a) Review operational assets for impairment;
 - (b) Invest in new property, plant and equipment in order to reduce emissions;
 - (c) Incur fines or other penalties for exceeding an emissions limit; and
 - (d) Purchase derivatives based on emissions allowances.

Action Requested:

- 2. Members are asked to indicate whether they agree that:
 - (a) The project scope should cover ETS financial reporting for:
 - (i) All types of entities (administrators, participants and traders); and
 - (ii) All types of ETSs (cap and trade, baseline and credit and other variations involving tradable emission allowances);
 - (b) The project name should remain “Emissions Trading Schemes”; and
 - (c) Environmental reporting and wider ETS impacts should be outside of the project’s scope.

⁴ Definition of “carbon footprint”: The amount of carbon dioxide released into the atmosphere as a result of the activities of a particular individual, organization, or community.

3 Generic Approach to Address Accounting for Different Types of ETSS

31. Each individual ETS has many individual attributes that distinguish it from other ETSS, but which appear unimportant for development of an appropriate ETS accounting treatment. Examples of such differences include⁵:
- (a) Start date of the ETS;
 - (b) Industries or installations targeted by the ETS (e.g. power generation);
 - (c) Geographic application (e.g. national, regional, or local);
 - (d) Target or cap on emissions (e.g. emissions are set at 20% below 1990 levels by 2020);
 - (e) Type of emissions covered (e.g. carbon dioxide);
 - (f) Government assistance to exposed industries;
 - (g) Type of penalty for non-compliance; and
 - (h) Mandatory or voluntary nature of the ETS.
32. With respect to point (g) (type of penalty for non-compliance) it is proposed that accounting for fines or other penalties arising from excessive emissions—excluding the obligation to remit emission allowances—is outside of the ETS project’s scope. Government revenue from fines is already covered by IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*. An IPSASB project on non-exchange expenses is likely to cover the expense side of the transaction, and IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* will also be applicable.
33. With respect to point (h) (mandatory or voluntary nature of the ETS) the definition of an ETS may need to include the idea that an ETS binds its participants such that there are negative economic consequences for a participant if its emissions exceed the emission allowances available.

Generic Approach to Different ETSS—Identify Key Factors

34. Despite the wide variation in ETSS in terms of the factors listed above, staff considers that it should be possible to develop accounting treatments that are applicable to all ETSS by focusing on a few key factors (or attributes or characteristics), common to all ETSS. Present accounting treatments provide some support for this view. For example, the summary of participants’ accounting approaches in the IASB’s November 2014 agenda paper (paper 6B)—included in the IPSASB’s ETS agenda papers for December 2014—focuses on emissions allowances and production of emissions and does not distinguish between different types of ETSS. However, a critical issue for this proposed approach will be to adequately address differences between the type of “allowances” resulting from the two main types of ETSS i.e. “cap and trade” and “baseline and credit” schemes. The GFS reporting guidelines focus on emissions allowances and production of emissions.

⁵ This list of ETS attributes is based on the headings in Appendix 2 of “Emissions trading schemes around the world” (Parliament of Australia, 6 June 2013), which provides an overview of the ETSS worldwide in 2013.

Differences between Cap-and-Trade and Baseline-and-Credit ETSs

35. Development of a generic approach will need to begin by researching different types of ETSs in order to review whether this approach works for different ETSs. Staff proposes to begin with the two main types of ETS—the cap-and-trade and baseline-and-credit schemes—and consider whether it is possible to describe their different mechanisms through common factors. In a cap-and-trade scheme the scheme administrator issues tradable allowances. Participants may buy and sell allowances, but at the end of a compliance period, are required to remit to the administrator allowances equal to their actual emissions. In a baseline-and-credit scheme each source of emissions of an entity is assigned a specific emissions limit for a period. After the end of the period, actual emissions are compared to the limit. If emissions fall below the limit, tradable credits are issued in the amount of the difference. If emissions are exceeded, credits must be purchased to cover the excess.

Consultation Paper Coverage

36. If the IPSASB supports this approach and further development and IPSASB discussions of accounting treatments also indicate that such an approach is viable, then the main part of the CP could explain that:
- (a) ETSs change and evolve over time, while new ETSs continue to be developed with new features, but that all ETS will, by their nature, share some key common factors; and
 - (b) One part of the CP's approach has been to identify those common factors that drive the financial impact of an entity's involvement with an ETS.
37. The CP may also need to include a specific matter for comment (SMC) on this point, which could ask constituents whether they agree with this generic approach. An alternative to this approach would be one that identified two or more types of ETSs (for example, cap-and-trade and baseline-and-credit) and then developed financial reporting applicable to each type of ETS.
38. Staff also proposes that the CP should include two appendices on ETSs:
- (a) One appendix lists ETSs considered during development of the CP. The appendix should be a reasonably comprehensive list, but acknowledge that it may not be exhaustive i.e. there may be ETSs which are not included in the list.
 - (b) Another appendix would provide illustrative descriptions of two or more ETSs. (For example descriptions of (a) a cap and trade scheme and (b) a baseline and credit scheme.)

Action Requested:

3. Members are asked to indicate whether they agree with the proposed “generic” approach, which would involve
- (a) Identification of those factors that are common to all ETSs and relevant for financial reporting; and
 - (b) Development of accounting approaches that focus on those key factors.

4 Common ETS Factors Relevant to Financial Reporting

39. This issue looks at the key factors, common to all ETSs, which appear likely to drive ETS financial reporting implications. Further investigation is needed to firm up the proposal below. Staff seeks IPSASB direction on factors that are likely to be important for financial reporting of ETSs.
40. Staff proposes that development of an accounting treatment should focus on accounting for financial elements (or a financial element resulting from the net result) arising from:
- (a) Emissions (or production of emissions); and
 - (b) Emission allowances, including emission allowance equivalents⁶.
41. The basis for this proposal is that these two factors appear to be the critical ones potentially resulting in economic consequences for participants and administrators. ETSs establish negative economic consequences for participants whose emissions exceed the limit covered by the emission allowances (and allowance equivalent items) that the entity holds. ETSs are constructed so that entities will prefer to avoid those negative consequences. Production of emissions could result in a liability, while emission allowances provide scope to avoid that liability and therefore provide economic benefits to the entity. From an administrator's perspective emissions from participants can indirectly result in a right to receive cash flows, because a participant entity may have insufficient emissions allowances to cover their emissions. Administrators can receive cash flows from their issuance of emissions allowances.
42. "Emission allowance equivalents" can be used in similar fashion to an emissions allowance, to cover an entity's emissions. For example, the European Unions' ETS allows entities to remit "project based certificates" in lieu of emission allowances for a limited percentage of an entity's emissions obligation.
43. Staff proposes that the following three factors, while important for development of an ETS accounting treatment, can be subsumed within the key factors already identified above.
- (a) Type of ETS, for example, whether an ETS is "cap and trade" or "baseline and credit";
 - (b) Price and issuance methodology of allowances (grant, sale, auction (restricted to participants or available to general public); and
 - (c) Timing constraints on emissions allowances and emission allowance equivalents.
44. These three factors can be viewed as relevant to the way that emissions allowances work, with implications for the recognition and measurement of different types of emissions allowances. For example, a baseline-and-credit ETS could be viewed as creating emissions allowance with different characteristics from those created by a cap-and-trade ETS, but both types of scheme create emissions allowances. The way in which an emissions allowance is issued (grant, auction or sale) will have implications for the recognition and measurement of any related financial element. Similarly recognition of emissions allowances would consider situations where there were timing

⁶ This discussion does not address the "accounting unit" issue, which was noted in the December 2014 IPSASB Agenda Paper 10.1. Emission allowances are identified as a separate factor from obligations arising from emissions, but those two factors could be linked into a single accounting unit and an accounting treatment developed that reflects the net effect of both factors (emission allowances and emissions obligations).

related restrictions on their application. Some emissions allowances can only be applied to a particular year—the “vintage year”— and years subsequent to that vintage year.

Accounting Unit and Emissions Management

45. Although the proposal separates out emissions allowances from the production of emissions, these two factors could be linked into a single accounting unit. ETS participants often manage their emissions and emissions allowances to achieve a positive or neutral overall position. Present financial reporting practices by ETS participants reflect this “emissions management” approach when they report the net effect of “allowances less emissions produced”. Staff and the TBG will consider whether an accounting approach that reflects the net effect of both factors (emissions allowances and production of emissions) could be appropriate and provide information on this for the IPSASB’s consideration.

Action Requested:

4. Members are asked to indicate whether they:
- (a) Support the proposed approach to identifying key factors, common to all ETSs, that drive ETS financial reporting; and,
 - (b) Agree with the initial focus on:
 - (i) Emission allowances and emission allowance equivalents; and
 - (ii) Production of emissions.

5 Next steps:

46. Staff and the TBG will:
- (a) Draft the first chapters of the Consultation Paper; and
 - (b) Provide the draft chapters and a second issues paper to the IPSASB’s June 2015 meeting.

Action Requested:

5. Members are asked to note the proposed next steps.

APPENDIX A: IASB MEETINGS—EMISSIONS TRADING SCHEMES

As of February 11, 2015

Introduction

- A1. This appendix provides a list of those International Accounting Standards Board (IASB) meetings that have involved discussion on the IASB's Emissions Trading Schemes (ETSs) project, since it restarted in September 2014.
- A2. For a full understanding of the papers presented, IASB discussions and the ETS related meeting outcomes please refer to the relevant IASB papers. For each meeting below there is a link to the IASB agenda papers, where the audio discussion is also available. Meeting updates are available from: www.ifrs.org/Updates/IASB-Updates/Pages/IASB-Updates.aspx.

February 2015

- A3. The ETS project is not planned for discussion at this IASB meeting.

January 2015

- A4. Agenda paper available at: <http://www.ifrs.org/Meetings/Pages/IASB-Meeting-January-2015.aspx>.
- A5. The IASB considered staff recommendations on:
- (a) Scope of the project (and related name change);
 - (b) Approach to the project; and
 - (c) Direction of the project.
- A6. IASB members supported the staff's recommendations that:
- *Scope*: The scope of the project should be set broadly to encompass:
 - (i) A variety of schemes that involve the issue of allowances for emission reduction and absorption projects, as well as ETS, and
 - (ii) Accounting by emitters, traders and entities that carryout projects to reduce or absorb emissions.
 - *Project name*: The name of the project should be changed to "Emissions Management Schemes"
 - *Approach*: Staff should:
 - (i) Take a "fresh start" approach to the project, and
 - (ii) Work collaboratively with other standard setters during the research phase.
 - *Direction of project*: Staff should develop a discussion paper which outlines:
 - The common characteristics of a wider variety of schemes, the accounting issues raised and the possible accounting or approaches that could provide a faithful presentation of the overall effects of the schemes identified;
 - The approach should not be restricted to identifying separate assets and liabilities but also look at the relationships between rights and obligations; and

- The IASB's developing Conceptual Framework should be the primary source for development of accounting approaches rather than existing Standards.

November 2014

- A7. Agenda papers available at: <http://www.ifrs.org/Meetings/Pages/IASB-Nov-14.aspx>.
- A8. First IASB meeting to discuss ETS issues since the project's restart in September 2014. This was an education session. No decisions were made.
- A9. Staff provided the IASB with background information about the type of schemes in operation and related accounting issues. Two common types of ETSs were described: 'cap and trade,' and 'baseline and credit' schemes. Staff research shows that there are diverse accounting approaches in use today.

APPENDIX B: DRAFT STRUCTURE FOR CONSULTATION PAPER

1 Introduction

- 1.1 Reason for project and CP's objective
- 1.2 History of the Project
 - IASB previous work and present project (*brief, high level*)
 - GFS reporting guidelines (*brief, high level*)
 - IPSASB decision to undertake the project
- 1.3 Conceptual Framework
- 1.4 Approach taken in this CP

2 Scope and Definitions

- 2.1 Types of Schemes
 - 2.1.1 ETS variation (Appendix A has list of ETSs reviewed)
 - 2.1.2 Main types (Appendix B provides illustrative descriptions)
 - 2.1.3 Common ETS attributes relevant to accounting treatment
 - 2.1.3.1 Discussion of attributes within context of the main types of ETSs
- 2.2 Types of Involvement (Administrator, Participant and Traders)
- 2.3 Scope
 - 2.3.1 Focus on ETSs (Other types of regulation are excluded from scope)
 - 2.3.2 Types of ETSs and types of involvement
 - 2.3.3 Scope exclusions
- 2.4 Definitions

3 Identification of Accounting Approaches

- 3.1 Review of existing financial reporting pronouncements and practice
 - 3.1.1 Administrators (e.g. GFS reporting guidelines) (*Refer to Appendix C for detail*)
 - 3.1.2 Participants (e.g. IASB developments) (*Refer to Appendix C for detail*)
- 3.2 Application of the Conceptual Framework and IPSASs addressing similar issues
- 3.3 Overview of the accounting approaches identified

4 Approach 1: (*To be determined*)

- 4.1 Introduction
- 4.2 Subsections

5 Approach 2: *(To be determined)*

5.1 Introduction

5.2 Subsections

6 Approach 3: *(To be determined)*

6.1 Introduction

6.2 Subsections

7 Presentation

Appendix A: List of ETs

List of ETs reviewed during development of the CP. (The list would aim to be reasonably comprehensive but its introduction would acknowledge that it is not necessarily exhaustive, i.e. some ETs may not have been included.)

Appendix B: Illustrative Examples of Main Types of ETs

B1. Cap and Trade

B2. Baseline and Credit

B3. Example 3 *(To be determined)*

Appendix C: Financial Reporting Pronouncements and Practice

Appendix D: Evaluation of Approaches (Options)

Appendix E: Glossary

Appendix F: Sources of Information

APPENDIX C: TWO MAIN TYPES OF EMISSION TRADING SCHEMES

(Excerpt from IASB agenda paper 6A, November 2014.)

Cap and trade schemes – EU ETS⁷

- C1. Cap and trade schemes were, and continue to be, predominant, with the European Union Greenhouse Gas Emission Trading Scheme (EU ETS), which started in 2005, as the largest scheme in the world. The description of cap and trade schemes in this paper focuses on the EU ETS⁸.
- C2. In a cap and trade scheme, a ‘scheme administrator’ (e.g. a government body of each EU Member State) sets an overall cap on the amount of particular greenhouse gas or other emissions that may be released by participants in the scheme during specified time periods, known as ‘commitment periods’. Participants operate the factories, power plants and other installations covered by the scheme (the ‘covered installations’). Over time, the overall cap is reduced to achieve the desired reduction in overall emissions.
- C3. In the EU ETS, the current commitment period (known as ‘Phase III’) runs from 2013 through 2020. The commitment period is divided into annual ‘compliance years’, which run from 1 January through 31 December. At the start of the compliance year, the scheme administrator issues the number of emissions allowances that equals the volume of the overall cap. Each emissions allowance offsets or ‘pays for’ a designated unit of regulated pollutant (e.g. under the EU ETS, one emissions allowance is equivalent to one tonne of carbon dioxide (CO₂)). Once allowances are used and remitted back to the government, they are cancelled and cannot be used again.
- C4. Within the overall cap, participants receive or buy emissions allowances, which they can trade with one another as needed. The scheme administrator uses an ‘allocation plan’, which identifies the number of emissions allowances that are granted free of charge to individual participants and the number that are sold or auctioned in the market place.
- C5. Under the EU allocation plans, the scheme administrators currently allocate the majority of the emissions allowances free of charge to the participants. The allocation of free allowances is intended to ease the transition process for participants but the number of free allowances will reduce over time.
- C6. In the EU ETS, emissions allowances are allocated as at 1 January and are delivered to participants by the end of February in each respective compliance year. By April of the following year, participants have to remit emissions allowances equal to their level of emissions during the compliance year. Harsh fines are imposed for any shortfall in allowances remitted by the due date. However, the imposition of a penalty does not remove the obligation to remit the required allowances.

⁷ This document does not cover all aspects of the EU ETS and should not be taken as being a comprehensive guide. European Financial Reporting Group (EFRAG) staff have kindly contributed to the research of this scheme but any errors in the description provided are the responsibility of IASB staff.

⁸ Further information about the EU ETS is available on the website of the European Commission. In particular, a fact sheet can be downloaded at http://ec.europa.eu/clima/publications/docs/factsheet_ets_en.pdf

- C7. Allowances are allocated on an annual basis but their use is not restricted to a particular year. Consequently, if a participant reduces its emissions below its cap, it can ‘bank’ the spare allowances to cover its future needs or sell them to another participant or trader. Alternatively, if a participant has produced emissions above its cap, it can either buy allowances in the market or it can borrow allowances from the following compliance year’s allocation (i.e. the participant may use allowances for compliance year 2 to settle obligations for compliance year 1). This borrowing is possible because the next year’s allowances are delivered in February, but the preceding year’s obligation is settled in April.
- C8. The EU ETS also allows ‘project-based certificates’ to be remitted in lieu of emissions allowances in fulfilment of a limited percentage of an entity’s emissions obligation. Generally, third-party providers undertake these projects to reduce emissions in regions outside the jurisdiction of the EU ETS and either use the resulting certificates to settle their own obligations or sell the resulting certificates on the open market to EU ETS scheme participants. The staff understand that certificates typically trade at a lower price than emissions allowances, primarily because of the limitation on the number of certificates that may be remitted. The use of such project-based certificates is becoming increasingly limited in the EU ETS scheme, but they are still usable in ETS schemes in other jurisdictions⁹.

Some other features of cap and trade schemes

- C9. This Agenda Paper focuses on the features of the EU ETS. Other cap and trade schemes have different features, which will be considered in due course later in the project.
- C10. For example, in the United States’ Acid Rain Program, allowances to emit sulphur oxides have been allocated for a period covering 30 compliance years. Each allowance has a ‘vintage year’ designation, indicating the first compliance year in which it may be used to offset emissions. Participants have in their accounts allowances with vintage years extending beyond the year 2030 that they may trade today, and those allowances may be carried forward (‘banked’) indefinitely. In contrast, in the EU ETS, allowances do not have vintage years because they only issued at the beginning of each compliance year and can be used to fulfil the current as well as future remittance obligations.
- C11. Some schemes allow participants to make up for a shortfall in allowances by paying into an environmental fund or making another form of a penalty payment. Again, this contrasts with the EU ETS, in which the imposition of a penalty does not remove the obligation to remit the required number of allowances.

Baseline and credit schemes

- C12. Baseline and credit schemes differ from cap and trade schemes in at least one important way. Instead of issuing emissions allowances equal to the cap before or near the beginning of the compliance year, the scheme administrator assigns a ‘baseline’ to establish the emissions limit for each covered installation in the scheme¹⁰.

⁹ Projects-based certificates are generally issued as part of a results-based financing programme (see Appendix).

¹⁰ The baseline may be set as a fixed quantity of emissions or it may be variable, based on some measure of output. This Agenda Paper focuses on schemes with fixed baselines, because of their similarities to cap and trade schemes.

- C13. A participant may emit up to the level of the baseline without incurring additional costs. At the end of the compliance year, if a covered installation's emissions:
- (a) Are below its baseline, 'credits' equal to the difference are issued; or
 - (b) Exceed its baseline, the participant has to purchase and surrender 'credits' equal to the excess.
- C14. The period of time between the issuance of credits and the deadline for remitting them is relatively short (usually only a few months), and thus trading activity is generally more limited than in a cap and trade scheme.

Comparative analysis of the schemes

- C15. Cap and trade schemes and baseline and credit schemes are both mechanisms to limit emissions. Usually, the goal of a scheme is to reduce the level of emissions produced by restricting a previously unrestricted emissions-producing activity. The initial cap or baseline that is allocated free of charge is usually set below the existing level of emissions, which is measured using historical data. The free allocation is then further reduced over time. This restriction in free emissions levels creates a new cost for activities that were previously free.
- C16. Under a cap and trade scheme, the free allocation of emissions allowances represents an amount of emissions that can be produced without incurring additional costs. The allocated emissions allowances can therefore be seen as establishing a baseline of emissions similar to the actual baseline in a baseline and credit scheme. Only if a participant's emissions exceed the established baseline will it incur additional costs. Hence, all other things being equal, participants in cap and trade schemes and in a comparable baseline and credit scheme are in a similar position if the level of allocated emissions allowances is equal to the assigned baseline.
- C17. The schemes differ in how the trading mechanisms are implemented. This affects the availability and liquidity of tradable instruments in the market. As outlined in the following paragraphs, baseline and credit schemes may have limited liquidity due to the smaller number of tradable instruments that trade for a shorter period of time. However, in a baseline and credit scheme that allows for banking of the credits to use in future compliance periods, the trading window will expand over time.
- C18. The number of tradable instruments issued under a baseline and credit scheme will be much smaller than under a comparable cap and trade scheme. For example, a utility with a baseline of 80,000 tonnes and actual emissions of 70,000 tonnes would receive 10,000 emission credits under a baseline and credit scheme. In contrast, in a cap and trade scheme in which the emissions cap is 80,000 tonnes, the administrator would issue 80,000 emissions allowances.
- C19. The scheme differences also affect the timing of when allowances or credits can be traded. In a cap and trade scheme, the emissions allowances are allocated at, or shortly after, the beginning of a compliance period. A participant may start spot trading upon receipt of the emissions allowances¹¹. In a baseline and credit scheme, tradable instruments are generated only if the emissions of a participant are below its baseline. Those credits will not be issued until after the end of the compliance period.

¹¹ EU ETS emissions allowances exist only in the form of electronic records on a single EU registry. The receipt or 'physical delivery' means the transfer of an emissions allowance on the EU registry into a participant's account.

Forward contracts

- C20. The availability of forward markets could make baseline and credit schemes more equivalent to cap and trade schemes. Upon receipt of its allocated allowances, a participant in a cap and trade scheme may sell the allowances in the market. If the participant is expected to continue to emit, it can simultaneously enter into forward contracts to buy back the number of allowances it expects to remit at the end of the period. If the forward rates adequately reflect the cost of carry, the agreed forward price exceeds the sale price by the financing costs. Essentially, the participant enters into a secured loan.
- C21. In contrast, a participant in a baseline and credit scheme cannot trade the baseline, because it is applicable only to the specific covered installation. However, a participant expecting an excess or a shortfall of credits in the compliance period may enter into forward contracts. A forward contract enables scheme participants to sell or buy credits at a certain date in the future, at an agreed price. Hence, participants can effectively sell (part of) their baseline. The 'physical delivery' of credits takes place when the participants receive the credits from the scheme administrator after the end of the compliance period.
- C22. Consequently, some consider that the accounting for baseline and credit schemes should be the same as cap and trade scheme that are designed to achieve the same objective.