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GN WS.7 Treatment of Emission Trading Schemes

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Response Note on BOPCOM Comments

Prepared by the GN drafting team for discussion at the joint AEG/BOPCOM meeting 13 July 2023

1. The guidance note (GN) WS. 7 Treatment of Emission Trading Schemes has been prepared for the updates of the System of National Accounts 2008 (2008 SNA) and the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6). The GN recommended option 4, Emission Permits recorded as financial assets with taxes on production recorded at surrender, at issuance cost as the preferred option.

2. The global consultation of the GN did not result in a preferred option: there was a roughly equal split between those preferring to treat the atmosphere as an asset (and therefore EPs as a non-produced non-financial asset) and those preferring to treat EPs as a financial asset. The issue was then discussed at the AEG meeting in October 2022. The AEG considered the five options, which can be grouped into two broad recording groups: the first, recording emission trading schemes as other taxes on production and the second, as the sale of an asset. The AEG acknowledged that this is a very complex issue that has solicited varying and strong preferences across all macroeconomic domains.

3. The AEG indicated that Option 4 - Emission Permits recorded as financial assets with taxes on production recorded at surrender as the preferred option. Before endorsing the recommendation, the AEG asked the WSTT to clarify the following issues which are similar to the concerns raised by the Balance of Payments consultation. The major concerns are highlighted below:

   - Should the permit be valued at the price at issuance (cash) or at the prevailing market price at the time it is surrendered?
   - How to treat permits provided freely?
   - What type of instrument should EPs be classified to?
   - Practical implications with regards to multi-country emission schemes?
   - What is commercial accounting recommending for the recording of EPs?

Valuation

4. One of the key issues is whether the EPs should be valued at issuance value or market value. In line with the 2008 SNA, all the options which proposed a tax including the financial asset approach, recommended for the recording of the tax, when the event takes place (emissions) and a liability has been created. A practical proxy for when emissions have occurred is at the time when the permit is surrendered.

5. Although market valuation is the preferred method of valuation in the SNA, interpretability and other challenges may arise if the EPs are valued at market prices upon redemption. This approach is referred in the GN as 4b. Emissions Permits recorded as Financial Assets with taxes on production recorded at surrender (market value). As market conditions change, the value of the emission permit will rise or fall in line with the prevailing market conditions. Accrual accounting will reflect current market conditions, which will impact government debt, net lending / net borrowing and net worth.

However, the actual cash received by government and corresponding liability of government will not vary with changing market conditions or expectations[1].

6. At maturity the financial assets will be transacted at face value, but at the time of auction the future value of EPs at the time of surrender is not known. There could be a large gap between the cash received by government for auctioning EPs and the amount of tax recorded at surrender based on the prevailing market value of EPs. To take an extreme example, if the government initially gives away EPs freely to nonfinancial corporations, but their value at surrender may be significantly different, should the government accounts reflect this as revenue while it has actually received zero cash? This difference between issuance value and market value will impact government savings and net lending/net borrowing due to the trading value of EPs when in fact the actual revenue (cash) has not changed.

7. To avoid this anomaly, the GN recommended option 4a - Emissions Permits recorded as Financial Assets with taxes on production recorded at surrender (issuance price). Otherwise, the tax recording can only be reconciled with the market value of the EPs by reflecting other economic flows in the revaluation account for the difference between the market and redemption (at issuance) price.

8. The table below denotes the cycle of permits and provides a comparison of the two variants of the financial asset approach.

	Option 4a (Cash)	**Option 4b (Market)**
At issuance	Government debt and liabilities are the value of the EPs at issuance.	Government debt and liabilities are the value of the EPs at issuance.
Prior to Surrender	Government liabilities follow the market value of the EPs while government debt (at face/nominal value) is maintained at issuance value.	Government liabilities follow the market value of the EPs while government debt could either be maintained at the issuance value or follow the market value.
At time of Surrender	Government liabilities are adjusted through revaluations to the issuance price and then there is a transaction at issuance price which extinguishes the liability (and debt).	Government liabilities at prevailing market value are extinguished through a transaction with the debt also extinguished, but the amount distinguished will depend on the value at which the EP debt was held.

[1] The change in the market value of EPs may impact the general government's gross and net debt liabilities depending on whether the recording of government debt is at face, nominal, or market value. The SNA and GFS recommend for government balance sheets to be at market values and most advanced economies do so. However, stakeholders predominately focus on nominal values.

9. **The GN proposes to record emission permits as a financial asset with taxes on production recorded at surrender, at issuance cost.**

Permits provided freely

10. The GN has demonstrated that permits are valuable and when given freely could be considered as capital transfers or as subsidies if they are deemed to reduce the intermediate expenses of non-financial corporations. However, it will be difficult to assign consistent values and countries may need to resort to imputations which may be questionable.

11. The market value of EP given freely will impact government gross debt (at market), however the face value of the debt will not be affected and remain at zero. However, if emission permits are transacted amongst corporations domestically or with non-residents they must be recorded in the accounts.

12. **If EP are issued freely, taxes will remain at issuance price, however it may not be reasonable to treat them as a financial asset. Additional guidance is needed to define and record EP given freely to account for the difference in the market and issuance price.**

Type of Security

13. The typology of the of the financial asset is an important issue and relates closely to whether to record the final tax at issuance value or redemption value.

14. With the financial asset approach the initial transaction is a sale of a financial instrument which can be recorded as either a negotiable debt instrument (AF.3) or other accounts payable/receivable (AF.8), and will subsequently be reflected as a tax on production only upon surrender of the EP.

15. There are strong arguments for the recording for either instrument – AF.3 or AF.8. There's a vibrant growing secondary market for EPs and non-emitters are active participants, suggesting that EPs resemble debt securities (AF.3). **The GN, however, argues that if EPs are valued at issuance value at redemption, then accounts receivable/payable (AF.8) seems the most appropriate instrument classification which aligns with the recording of the tax in the government accounts.**

Multi-country

16. Another complication pertains to international or multi-country emission permit schemes / arrangements, such as the European Union Emission Trading Scheme (EU ETS) which covers all the European member states, and the Western Climate Initiative which covers the U.S. states of California and Washington as well as the Canadian provinces of Québec and Nova Scotia.

17. With these types of schemes, the issuing country will receive the proceeds of the sale of the permits through an auction process, however the use (surrender) of the permits can be in a completely different jurisdiction, which could result in countries being net exporters/importers of emission permits without any direct correlation with emissions in that country.

18. In the absence of a centralized body (or a security-by-security database for EPs) to co-ordinate the sales and purchases of emission permits on behalf of the participating regions / countries, multi-country schemes may create asymmetries within national accounts when differences arise between the values of permits issued by the country and the corresponding amounts surrendered to the country. As corporations are generally indifferent to who originally issued the permit they are

surrendering, the sectoral flows related to the original issuance of the permits may not match the sectoral flows at surrender. Currently, in the European Union practice, corporations purchase and redeem EP in the same territory. However, as cross border transactions become more important, challenges in recording due to insufficient data will amplify. Cross border trading in EPs is data demanding of all the options considered.

19. **The drafting team acknowledge that the proposed option poses certain practical challenges for compilers and may also be more demanding compared to the others. Since, the recommended option will require information for each permit on the issuance and redemption prices**.

Accounting

20. Businesses do not provide clear and uniform disclosures of emission permit schemes' impacts to the market. It has been noted in the GN that when permits are used to offset GHG emissions they may be reflected as current assets and valued similarly to inventory valuation. In other cases, they may be recorded as intangible assets or not disclosed altogether. Consequently, it is difficult to obtain consistent information from a corporation's financial statements and therefore, **the GN recommends accessing government information on the issuance and redemption of EP if available and accessible**.

Way Forward

21. Given the measurement issues identified it is proposed to establish a workshop, with the objective of providing practical guidance on the measurement of cross border EPs transactions and treatment of EPs given freely. As emission trading schemes may evolve significantly over time, including the creation of new modalities, this is an area that needs continuous monitoring and research, and potentially also further discussion on the way of recording

Questions for the AEG/BOPCOM

1) Do you agree that the option 4a Emission Permits recorded as a financial asset with taxes on production recorded at surrender at issuance is the most prominent alternative for the current 2008 SNA recording of emission permits?
2) Do you agree with the classification for Emission Permits as accounts receivable (pre-paid taxes) / accounts payable?
3) Do you agree with the proposal to provide practical guidance on the recording of and measurement for EP provided freely, including practical guidance on the measurement of cross border transactions?