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The Credit Crunch Has More Episodes to Run

The heady mix of a credit crunch, overvalued euro, overvalued pound and weak dollar, is a witches broth for global finance ministers, trying to stave off economic slowdown and possible recession.

Take the UK - steady growth for the last ten years, but what sort of growth? An economy underpinned by a furious housing market totally reliant on continuing credit and worse, mortgages granted to customers who have totally overreached their normal borrowing power.

This brings us neatly to the Northern Rock crisis - the first casualty of this interbank credit crunch. The UK government refused to bite the bullet and face down their shareholders. As Mrs Thatcher said "you can't buck the markets". The Rock's ordinary depositors should have their savings protected but the bank should have been allowed to fail - that is the element of risk in a capitalist system. Instead, a staggering £25 billion and counting has so far been spent to avoid political embarrassment and protect jobs in a Labour stronghold - the north east of England.

The crisis in the money markets has certainly manifested itself as a liquidity problem. Banks have been reluctant to lend to each other, with the result that interbank rates have soared, and accordingly banks and other lenders dependent upon bank finance have had a very difficult time. It was this dependence which did for Northern Rock.

It is also apparent that Northern Rock faces a solvency problem. The collapse of confidence in the British housing market has reduced the market value of its mortgages. Even if the Rock could liquidate all its mortgages tomorrow, it could not raise enough money to repay its depositors and the Bank of England in full, because of the lower market prices of mortgage assets. The upshot is that the government will almost certainly have to nationalise Northern Rock after putting it into administration.

The cost of the whole operation will therefore be determined by expectations about the housing market and the economy in the years ahead. This is a problem not only for the UK government and Northern Rock, but also for global capital markets and financial authorities. Fears of a housing meltdown have created doubts about the underlying solvency of some banks and forced all of them to cutback on their lending.

The world has moved from a period of easy credit to a period of tight credit: from a period when cash is on tap to a period when cash is on top. This has happened before, and will happen again, but periods of tight money are inevitably periods of suffering in business, in housing, in jobs and therefore in politics. We have lived through a massive asset price bubble both here and in the US, as well as in selected other countries, including Ireland and Spain, and when the bubble bursts there is bound to be pain.

The UK's problems are multiplied by its incredible reliance on financial services; the City of London provides approximately 20% of UK GDP. Any slow down in this sector will provide huge problems for the Brown government. A further structural problem is Britain's long-term sick and unemployed. The UK market, principally the powerhouse of the south east of England, has created millions of jobs - virtually all taken by young east European immigrants who are well educated, keen to work and get on. Many who have been in the UK for several years are now moving into middle management. They are highly valued by UK employers. Brown must grasp this benefits nettle and change the culture. Many do not believe that he has the political courage. The effect on the public sector finances will be severe.

In Europe, which still has significant industrial capacity, the weak dollar is causing havoc for those companies who sell in dollars, but have costs in the strong euro. Take Airbus - despite their huge order book, they sell their product in dollars, the currency of the global aviation business. On a positive note some 30-45% content of each Airbus sold is US-sourced, providing some relief. Further EU integration is a positive step, but care will have to be taken that the tendency to meddle with markets and legislation is balanced with pro-growth measures.

The USA is still the world's most awesome economic regime, despite a weak dollar and a colossal deficit, the ability to innovate and create wealth remains unsurpassed. The financial centre of NY has absorbed Sarbanes Oxley and is regaining ground lost to London. These two financial titans will struggle for supremacy for the foreseeable future.

In essence 2008 will provide great difficulties for some but benefits and opportunities for many. WCR will continue to observe and comment on the global business scene; one thing we are sure of, is that whatever the obstacles entrepreneurs will as always emerge and innovate, the spirit of wealth creation and capitalism will continue to thrive. ■

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Global Financial Market Turbulence – Causes and Consequences

René Karsenti is Executive President of the International Capital Market Association (ICMA)

We have heard much in the last few months about the causes of credit, liquidity and risk management turmoil. It is as yet still too early to draw definitive conclusions about either the causes or consequences of recent global financial market turbulence, however the following are some reflections on recent events from the perspective of an international self regulatory financial market organisation.

We are now in a period of what I would consider to be a long overdue reassessment and repricing of risk, after immediate and intensive corrective actions to preserve liquidity in financial markets. The market turbulence of last summer illustrates also the consequences of a period of over consumption and over production of complex financial products which was combined with serious difficulties in monitoring the associated risks. Indeed the benefits which should normally have been derived from financial innovation such as complex securitised products have in fact been associated with a new configuration of risks. We have observed over the years the eagerness of certain financial intermediaries to shift to the "originate and distribute" model, while weakening their due diligence process and an immense investor appetite to increase returns by assuming complex risks that were not always fully understood. The situation was compounded by the outsourcing of important internal due diligence responsibilities to credit rating agencies and other third parties. At the same time the use of such new complex instruments was not supported by sufficiently adequate and comprehensive risk monitoring functions; it also involved a global distribution which included investors located in jurisdictions lacking sophisticated oversight.

Inevitably, the market has become much more cautious. Risk is being repriced and the market has yet to recover. This also has an impact on the quantity of new issues, with less supply as M&A and private equity activity has decreased; and less demand as hedge funds become less active. And there will also be an impact on quality, as arranging banks become much more conservative in their assessment of creditworthiness, and issues with weaker covenants become more difficult to sell to investors.

Nevertheless, despite this serious turbulence during the summer, we should take some comfort in the fact that a resilient financial infrastructure exists in our markets, in particular in the area of clearing and settlement which has continued to operate without any failure.

Undoubtedly, the turmoil in financial markets will affect real growth in the international economy, but it is much too early to say how large the downside will be. That depends on whether the turbulence is limited to a (healthy) short-term market correction or the start of a prolonged downturn. I do not believe that anyone yet knows this for certain. But clearly such turbulence has highlighted, I believe, the need to enhance substantially practices in the following areas: prudential supervision; risk management, transparency and due diligence processes for structured products; the role and methodology of rating agencies; valuation of complex instruments and the need for enhanced best practices.

Role of central banks

The central banks were right to intervene from August 9 onwards by pumping liquidity into the system, not just overnight but for up to three months, and in some cases by expanding the range of collateral they accepted in exchange. Initially, some commercial banks hoarded liquidity (eg by investing in Treasury bills), but in time they extended sufficient liquidity to the wider market. Central bank intervention does seem to have had an effect in steadying the market; and commercial and investment banks have also helped to calm the market by giving a lead for reputational – rather than purely financial – reasons: eg by deliberately drawing on Fed funds when they did not need to do so.

Central banks do have the opportunity to influence the outcome by reducing interest rates if necessary, as the Fed did on September 18. A separate question, when they set interest rates, is whether central banks should in future target asset prices as well as CPI measures of inflation. In general, when they set interest rates, central banks already take account of the impact of asset prices on inflation. But it is difficult to hit two different targets simultaneously.

Central banks were clearly right to inject liquidity into the market in response to financial market turbulence. The difficulty they face now is how to maintain confidence in the system as a whole without giving the impression that they will always bail out individual institutions, and so encourage imprudent risk-taking in future – moral hazard.

The turbulence in financial markets has presented a classic case for central bank intervention on financial stability grounds. But the difficulty in this case has been that, with limited exceptions such as the classic bank run on Northern Rock in the UK in September, the problems have emerged initially outside the traditional banking sector.

Regulation

The financial crisis has also raised the related question about where the dividing line should be drawn between financial institutions that pose potential risks for the financial system as a whole, on the one hand, and financial institutions that central banks can allow to become insolvent without posing such risks, on the other. And if certain non-bank financial institutions pose systemic risks, should they continue to be supervised more lightly than banks?

In Europe it is not clear whether Basel II and the Markets in Financial Instruments Directive (MiFID), if they had come into effect earlier, would have made a significant difference either in preventing financial market turbulence or in resolving the problems that have emerged, although risk and conflicts of interest management would have been subject to greater self analysis by financial institutions and enhanced regulator oversight in some jurisdictions.

One particular problem is that the treatment of collateral under Basel II may need to be rethought. The question is whether Basel II gives excessively generous terms to collateralised instruments and covered bonds (eg in relation to unsecured interbank lines). And if the authorities need to rethink elements of Basel II in relation to the banking sector, this may also have implications for Solvency II in the insurance sector.

But the G7 has now set an agenda via the Financial Stability Forum covering liquidity and risk management, accounting and valuation of financial derivatives, role, methodologies and use of credit rating agencies, and principles of prudential oversight including the treatment of off-balance sheet principles. To which I would only add the issue of due diligence by buy-side institutions.

We will see what emerges in due course and will seek to contribute constructively to the outcome in the interests of promoting an efficient and stable market environment in the interest of all constituencies. However it cannot be in anyone's best interests to rush into a 'knee jerk' reaction to these events resulting in unnecessary regulation which could stifle future innovation and development in the capital market. None of us wish to see 'unintended consequences' as result of hastily drafted regulation, which could result in financial transactions becoming more risky. Diagnose before prescribing!

As an organisation representing a broad range of capital market constituencies with a European focus, ICMA's objective remains to ensure the continued smooth functioning of the markets within the context of a resilient and stable infrastructure while limiting unnecessary regulation which could restrict innovation and efficiency in the future.

As a self-regulatory organisation we believe in the value of industry-led solutions to market issues and continue to stress the importance of dialogue with regulators and a measured approach. ■

1. *Based on the speech given to the EURO50 Group, Washington, October 21, 2007*

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Recent Events in the Capital Markets

Angela Knight is Chief Executive of the British Bankers' Association

Markets hate uncertainty. The less clear the outlook, the less likely that any significant fundraising will take place on the capital markets. By and large, they can accommodate risk as long as they know the scale of it – accurate risk pricing is one of the greatest achievements of the financial markets in recent years – but when it comes to things they do not know, and cannot quantify, the markets tend to retreat.

The year 2007 is best characterised perhaps as a year of uncertainty in the markets, the principal uncertainty being the whereabouts of the risk associated with US sub-prime mortgage debt. The global economy looks very different now compared to how it looked at the start of the year, when our only worry seemed to be whether the rest of the world's economies could hope to keep up with China. Now the rules have changed, and so has the vocabulary we use to describe them (at the BBA we have captured the zeitgeist by adding the terms "credit crunch" and "sub-prime lending" to our online glossary of banking terms).

After an extended period during which it regularly launched record numbers of companies on its markets, London Stock Exchange has had to deal with a fall in the rate of flotations. At the same time as the rate of flotations was slowing, the rate of private equity buyouts began to slow as well, taking an inevitable toll on merger and acquisition activity. The valuations of private company sales to private equity fell by 14 per cent between the second and third quarters of this year, according to BDO Stoy Hayward's quarterly PEPI index. Added to this has been the collapse of some high-profile deals, not least the Delta Two bid for Sainsbury's.

Meanwhile some of the world's biggest banks have suffered significant falls in their valuations as the markets have tried to determine just who this slowdown will affect next.

The most visible casualty of this uncertainty was the UK bank Northern Rock. Images of the queues which formed outside some of the bank's branches flashed across the globe in early September. That this should happen in the world's greatest financial centre shocked the markets (and probably generated more than a little schadenfreude as well).

The fundamental issue at Northern Rock was one with which anyone in business will be familiar: cash flow. The bank had good assets but depended on the ability to borrow money in the short term from other banks (via the interbank market). That cash all but dried up as banks' concerns grew about the likely impact around the world of the sub-prime mortgage crisis. Northern Rock therefore requested an overdraft facility from the Bank of England, and it was the announcement of this overdraft facility – the so-called "lender of last resort" facility - that led to the extraordinary scenes on our high streets.

This problem was compounded by communication. The Treasury, the Financial Services Authority and the Bank of England united on Friday 14th to explain to the markets that Northern Rock was not in financial trouble. The markets understood this and moved on. The bank's customers took this to mean the reverse. The very act of issuing that joint statement evidently worried enough Northern Rock savers to set queues forming. Having been told not to panic, people panicked. Courtesy of the worldwide web and 24-hour rolling news, this spread more quickly than ever before. Images of queuing customers flashed across our screens. And the queues begat queues.

It is a problem we hope we will never face again, but one it is all too easy to imagine happening. In a world where we can all take photos with our mobile phones and ping them into newsrooms and onto websites, images flash around the world devoid of context or explanation. All any Northern Rock saver had to see was a queue outside the bank for the panic to take root. It is a perfectly understandable reaction and we all need to learn from it. We all need to take time to understand the fears of the people who queued for so long to take their money out. Who on earth ever thought "lender of last resort" was an appropriate term for the Bank of England? Who would not be frightened to death to discover his bank had turned to a last resort?

In a very real sense the current troubles at Northern Rock were started by the concerns of a public who did not believe the reassurances of the bank, the regulators, the Chancellor of the Exchequer, the Bank of England or even the army of market commentators who called for calm. Realistically we cannot and should not expect customers to remain calm just because we say so.

But banking is one of the UK's few global industries, providing jobs for more than three million people and pumping more than £50 billion annually into the UK economy. The UK banking system is immensely strong and stable and when there are problems they are resolved quickly and usually publicly. Therefore it is crucial that we use the opportunity to learn some useful lessons.

We need to do more to explain what we do. Yes, the international financial markets are exceptionally complex, and growing ever more so. Yes, we are devising ever cleverer ways to spread risk across the financial system rather than concentrating it in a few financial products. And yes with every innovation there is more to understand, more to regulate. But we need to make more efforts to communicate these innovations and to explain how we work to safeguard customers' money at all times.

Now the blame game is being carried out in earnest – and in public. The problem is there are too many people or organisations who might share the blame. As well as the management team of Northern Rock, who ultimately take responsibility for the bank's business strategy and its consequences, there are the hapless borrowers of sub-prime loans in the USA, the big firms who packaged their debt and sold it on through collateralised debt obligations (CDOs), the agencies that rated them and even the institutions that bought them, and that is before we even get on to the regulators who are seen to have failed to anticipate and head off the problem. Much of the blame is now being levelled at the members of the UK's tripartite regulatory structure: the Treasury, the Financial Services Authority and the Bank of England.

We need a regulatory structure that people understand and trust. Financial stability and transparency should always be its guiding principles, as it should be for all participants in the UK's growing financial services sector.

The next steps we need to take are clear:

- the Government, working with the financial services industry, needs to work to rebuild the UK's international reputation following the global publicity given to the queues outside Northern Rock;

- the tripartite regulatory structure of HM Treasury, the Financial Services Authority and the Bank of England should remain (itmay not be formalised in other countries, but it nevertheless exists: it is inconceivable for instance that a finance ministry and central would not communicate during a banking crisis). However it needs to agree a clearer allocation of roles and responsibilities;

- the Bank of England should offer a standing facility at a lower rate during times of market stress, rather than sticking to its penalty rate of one per cent above base. Further thought also needs to be given to removing the stigma which currently attaches to any institution which approaches the Bank of England for funding;

- an investigation is needed into why the internationally-recognised system for assessing banks' liquidity failed to alert regulators to the problems at Northern Rock;

- deposit guarantees are only necessary when the regulatory system fails a financial institution and its customers. HM Treasury's current review of the scheme should also look at

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- what might be done in the earlier stages of the regulatory process; and

- we need an urgent reality check on the way we implement European directives in the UK. The Governor of the Bank of England told MPs that one of the reasons for his hesitation as the crisis developed was that a European directive appeared to block his intervention. Would other countries have locked the same requirements into their laws as we have?

And finally we need to avoid a witch hunt. The UK's financial system is the best in the world because it innovates tirelessly, inventing new and safer ways to invest and grow wealth. It must not get dragged into playing the blame game. ■

The Three "Gateways" to Establishing a More Open and Better Regulated Transatlantic Market

Anthony Belchambers is the Chief Executive of the Future and Options Association

"At the same time, as our markets become increasingly interconnected, the regulatory friction from difference national regimes becomes more significant" (Christopher Cox, Chairman of the SEC, 9/10/07)

"We should get rid of as much regulatory duplication as possible. If another regulator offers an equivalent standard of regulatory and equivalent enforcement – have the courage to rely on them" (Charlie McCreevy, EU Commissioner, 7/3/07)

In July 2005, a number of industry associations on both sides of the Atlantic established the EU-US Coalition on Financial Regulation to argue the case for expedited delivery of transatlantic regulatory recognition and "targeted" rules' convergence as key drivers for establishing a more efficient and open transatlantic market in financial services and products.

The case for accelerating and delivering improved market access and regulatory simplification of transatlantic cross-border business is now overwhelming. Between them, the EU and the US are the world's largest trading area accounting, collectively, for 80% of the world's financial services business, providing nearly seven million EU and US jobs and accommodating stock and bond flows in excess of US$51.3 trillion per annum. Fortunately, the dialogue has been re-energised by growing recognition of the need for closer regulatory engagement and a less jurisdiction-based approach by regulatory authorities, as well as the adoption at the April EU-US Summit in Washington of a "lighthouse project" to "take steps towards the convergence, equivalence or mutual recognition, where appropriate, of regulatory standards based on high-quality principles".

The work of organisations like the International Organisation of Securities Commissions and the Financial Markets Regulatory Dialogue has helped to establish a more coherent regulatory approach to cross-border financial services business. However, continuance in nationally differentiated and, often, conflicting financial services rules and the consequential regulatory duplication and confusion are out of step with an increasingly global financial marketplace. This, in turn, has resulted in the imposition of unnecessary costs on transatlantic financial services business and generated regulatory confusion and restrictions on access and choice for customers.

Simplifying the current framework of EU/US regulation that sits over cross-border financial services business will, understandably, be a major undertaking, but significant reduction in regulatory conflict, duplication and cost is a "win win" for all the "stakeholders" in the transatlantic marketplace. *Investors, issuers and consumers of financial services* will have improved rights of access and the benefit of greater choice in being able to meet their global investment, trading and risk management needs and accessing a wider range of sources of capital and providers of financial services – particularly pressing for globally-aware institutional and corporate end-users. *Financial service providers* will benefit from being able to better harmonise their internal and customer-facing procedures across all their EU-US operations, reduce the incidence of inadvertent compliance breaches and secure much-needed business and cost efficiencies. *Market infrastructure providers* will be able to offer investment, trading and capital-raising facilities more widely and so generate deeper pools of liquidity. *Regulatory authorities* will be able to deepen their common understandings and develop greater trust and cooperative working relationships across a common set of regulatory frameworks driven by shared values and regulatory outputs.

In September 2005, the Coalition, working with its appointed external counsel, Clifford Chance LLP, published its first report, "*The Transatlantic Dialogue in Financial Services: The Case for Regulatory Simplification and Trading Efficiency*" which set out a consensual transatlantic industry manifesto for modernising the regulation of cross-border transatlantic financial services business. Volume 1 of the report set out eleven priority areas for regulatory action (which have since been amended and updated to reflect current thinking and will appear in revised form in the Coalition's second paper). Volume 2 comprised a comparative analysis of the licensing and business conduct rules of the SEC, CFTC and, by way of example, four member states of the European Union, namely, France, Germany, Spain and the UK.

As indicated above, the Coalition is intending to produce a second paper (likely to be published in January/February 2008), which will set out the three "gateways" for modernising the regulation of transatlantic financial services business ie exemptive relief, regulatory recognition and "targeted" rules' convergence with the principal focus being placed on wholesale as opposed to retail investment services and dealing activities.

The advantage of *exemptive relief* is that it can be delivered on a "fast-track", unilateral basis. All that is necessary is for a host state to allow foreign broker-dealers to carry on their business with institutional customers on the basis of compliance with the licensing requirements of their home state regulatory authorities. This is particularly appropriate for wholesale financial services business, where there is an "equivalence in arms" between financial service providers and their institutional customers in terms of knowledge and product understanding.

The increasing focus given by the US SEC to facilitating non-US broker dealers and exchanges to be able to carry on certain forms of financial services business with US customers without requiring full SEC registration is a welcome step forward. It will undoubtedly help to establish a more efficient and coherently regulated transatlantic market. The SEC's eagerly anticipated concept release (now expected to be published in January 2008) is expected to set out its approach to exemptive relief and regulatory recognition and give an indication as to how some of the more burdensome and restrictive conditions set out in its Rule 158a6 will be alleviated. The underlying questions, however, are how much compliance with non-US rules will, in reality, be "substituted" for compliance with US rules; what is the degree of preliminary regulatory analysis that will be necessary in order to justify exemptive relief for a foreign broker dealer (or exchange); and what categories of business and US customers will fall within the scope of the relief?

Interestingly, the US Commodity Futures Trading Commission (CFTC) is known for its long-standing framework of exemptive relief based on regulatory recognition whereby foreign broker-dealers licensed by regulatory authorities with comparable standards of regulation may, under its Part 30 Rules, enjoy rights of customer access in the US based on the regulatory standards of their home-state licensing authorities. A comparable approach by the SEC would demonstrate that the US now has a common approach to international regulatory ▸▸

engagement and, at the same time, would build on what is perceived to have been a successful and pragmatic framework for recognition/exemptive relief which has not resulted in any diminution in acceptable regulatory standards.

So far as the "recognition" of non-US exchanges is concerned, the position is less clear but it would appear that the SEC's approach may be to look to facilitate access not on the basis of unilateral exemptive relief, but on the basis of mutual regulatory recognition and reciprocal rights of access. Referring again to the CFTC, it has afforded non-US exchange rights of access through a process of no action relief whereby foreign exchanges, which are able to demonstrate that they are licensed and regulated according to comparable standards prevailing in the US, are allowed to offer their services and products in the US on the basis of compliance with the licensing requirements of their home-state regulator.

The CFTC have had these rules in place since the early 1990s and they are generally accepted to have worked well both from the point of view of foreign broker-dealers and exchanges and of the regulatory authorities themselves - and have not generated any unacceptable diminution in high standards of regulation.

"*Regulatory recognition*" is where regulatory authorities accept or "recognise" each others' licensing, prudential and business conduct rules on the basis that they are driven by common regulatory values, objectives and procedures, particularly in terms of market integrity and investor protection to the point where they can engage in a significant level of mutual reliance, operational delegation, cooperative actions and comprehensive information-sharing. The Coalition believes that, if recognition is to be durable and fully deliverable, it should be based on:

- shared high standards in public policy objectives and regulatory principles, which would set a policy perimeter around onward rules' development, but which would also allow for the continuation of rules' differences (where they deliver comparable outputs);
- shared "principles for better regulation" for introducing, evidencing the need for and developing financial service rules; and
- recognition of the need to avoid unnecessary rules' changes which can be particularly damaging for the large numbers of small or purely domestic European and US businesses, and for whom transatlantic regulatory convergence offers little or no commercial advantage.

The thirty IOSCO Principles (or, as some commentators put it, "IOSCO+") could provide an internationally recognised basis for measuring the quality of rules' outputs and regulatory objectives for regulatory recognition purposes insofar as:

- they are driven by the three objectives of protecting investors,delivering market integrity and reducing system risk objectives that are shared by most well-regulated jurisdictions;
- the eight categories of principles address the need for high standards to be adopted by regulatory authorities, issuers, intermediaries and exchanges;
- the members of IOSCO, which, between them, are responsible for the regulation of over 100 jurisdictions and 90% of theworld's securities and other financial markets have already endorsed (but not necessarily adopted) these principles, as an appropriate means of regulatory measurement;
- the use of such a global standard by EU and US regulatory authorities would rebuff any suggestions that recognition had become a transatlantic "closed shop" and will establish a means of measurement which could be deployed by other key financial service jurisdictions and centres to enlarge the framework of regulatory recognition.

It is anticipated, however, that mere endorsement by a regulatory authority of the thirty IOSCO Principles will not be sufficient for evidencing the quality of its regulatory policy, standards and processes. Regulatory authorities will need to be able to demonstrate, in real terms, that the Principles lie at the heart of their regulatory culture, objectives and processes – and it can be anticipated that a significant percentage of the "endorsing" authorities may find that they are not able to pass an "IOSCO + " in-depth analysis.

The third "gateway" is "*targeted*" *regulatory standardisation or convergence*. It is important that rules' convergence is not driven by any concept of "harmonisation for harmonisation's sake", but rather by where there are (a) differences in jurisdictional rules which are so out of line that they prevent the delivery of regulatory recognition (in which case the process of convergence should only be to the point that is necessary to facilitate recognition) or (b) convergence would deliver improved commercial efficiency for regulated firms or better customer understanding or otherwise enhance market access and trading efficiencies.

The second report of the Coalition will identify a number of areas where convergence would be of real use in establishing a more efficient cross-border transatlantic marketplace (although it is recognised that some of these priority items could be addressed through the alternative "gateways" of exemptive relief or regulatory recognition). It is also recognised that, while the convergence "targets" are categorised in terms of industry priority, some of them may require protracted negotiation or require changes in primary legislation. The Coalition's position, however, is that, even though they may not be "quick wins", they are all are priority issues and merit expedited attention. While this list is still the subject of consultation with firms, it currently comprises seventeen issues which are grouped into three distinctive sets of priorities. They range from, for example, classification of counterparties through to the development of a more converged approach to anti-money laundering verification requirements.

There is no doubt that the three "gateways" will generate a major shift in regulatory policy and processes and will have a modernising effect on regulatory practice that will make it fit for the purpose of supervising a more globalised marketplace. However, this is not just about enhancing regulatory efficiency and effectiveness. There are also real commercial advantages to be gained from the dialogue for both financial service providers and their counterparties and customers. If these latter goals are to be achieved, it is critically important that the process of negotiation involves, on a structured and regular basis, all the "stakeholders" in securing a better-regulated, more open and commercially efficient transatlantic market – and that means regulated firms, issuers, fund managers and customers. As it was put in the Coalition's first report, "*Moreover, the critically important economic and commercial objectives of facilitating innovation, enhancing efficiency and liberalising customer choice can only be attained if the process of change is taken forward on a genuinely consensual basis in which all the 'stakeholders' in the process are not just consulted, but become an integrated part of the process and their views given full and proper consideration. To do anything else will be to achieve less.*" That continues to be the case. ■

Interactive Disclosure: Closing the Gap Between Corporations and Investors

David M Blaszkowsky is the Director, Office of Interactive Disclosure, at the US Securities & Exchange Commission

Financial disclosure lies at the foundation of the capital markets in theory and practice. A new set of technologies, based on a standard called XBRL, or eXtensible Business Reporting Language, promises to create a new world for disclosure, which can and will feature the liberation of data from the printed page (or its electronic avatar), and the democratized availability of it - all of it, with precision and promptness - to investors globally. Now is the time for corporations worldwide and their advisors to get to know and experiment with XBRL, and for investors to demand it and the applications that will realize its benefits. It is the future for financial and business reporting.

From Gutenberg to the web, but disclosures are still static and unequal

Sumerian cuneiform tablets have the earliest records of business recordkeeping. But the invention of double-entry accounting in Italy, nearly simultaneous with the introduction of the moveable type printing press, made real the possibilities of both meaningful disclosure of financial reporting and its distribution. The creation of the modern stock corporation made financial disclosure compelling as good practice and as a legal obligation, at least to insiders. In the US, disclosures started to circulate informally, or rather were teased out, in the mid-19th Century by such pioneers as Henry Varnum Poor of Poor Publishing (especially for railroad and canal companies), and selected material began to be mandated by the growth of "Blue Sky" laws in several states. But, it was primarily with the securities laws of 1933 and 1934 that disclosures, at least for public companies, became standardized, mandated, and publicly available at Securities and Exchange Commission (SEC).

Regular, reliable and timely disclosures, in addition to other market devices, revolutionized capital markets by enabling investors to perform meaningful securities analysis, both on and across companies, and to develop ever more sophisticated and (usually) insightful techniques for valuation and portfolio selection.

The SEC's development of EDGAR in the 1980s foreshadowed a new era: easy availability of data to all who wanted it, or at least those with an expensive account and a costly data connection. What really changed the status quo of financial reporting was access to EDGAR through the web by even the retail investor. Company filings became simultaneously available to everyone – but in massive form, difficult to parse or to search.

Therein lies the challenge. The disclosures are out there, but their essence is still locked in the page-based, print-driven paradigm of Gutenberg and even the Sumerians. The content is locked in charts and tables and numbers that look like data, but are, to the computer, merely formatted characters. The HTML filings in EDGAR are just characters with formatting – that is all HTML is, powerful as it has been. It is not innately useable data, though, and it can't be. True, it can be parsed by complicated algorithms, but the content is nearly as static as the characters on that Sumerian clay tablet.

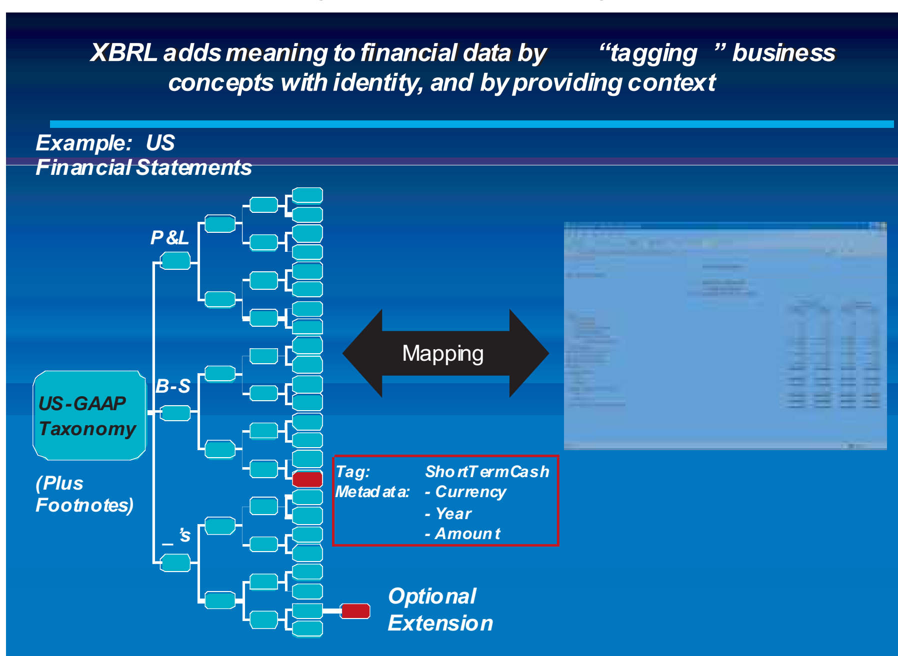
Sure, institutional-class investors and analysts can pay thousands of dollars to get the data through intermediaries, as keyed in by massive teams of data-entry operators, replete with errors and delays. And only some of that data will trickle to the retail investor with more delay and diminished detail. Is unequal disclosure really, truly meaningful disclosure?

The environment is data-rich when compared to even 10 years ago, but this is still not the realization of "disclosure" in the full sense of the word, or in terms of what is possible and even what is most useful. Fortunately, newer technologies are ready to break apart the old model of disclosure and liberate financial reporting.

From page to data: XBRL and interactive data

"There is the opportunity to completely transform the kind of information that investors are getting from something static and very difficult to use, to something that is very easy to work with and which provides a great deal more information," as SEC Chairman Christopher Cox said recently in a *Wall Street Journal* interview. From static to dynamic is theme, also, of the XML (eXtensible Mark-up Language) family-developed in the mid-90s to go beyond the limitations of HTML by giving every component in a web page an identity (or tag) and context (metadata). XBRL is just XML-tailored for business reporting. With those in place, it becomes possible - even ordinary - to extract data, write applications, monitor pages across the whole web. Investors and analysts can look for something unique, something that is distinctive. A new world then begins to emerge.

Think of it as bar coding for financials. Every account in a financial statement or other disclosure is tagged with its own code, and linked to that code are the numbers for particular periods. As financial statements have a hierarchical logic, that logic of tags (in technical talk, a taxonomy) can cover all of the concepts, from the P&L to the balance sheet to the footnotes and beyond. All that companies need to do, with the help of the growing number of user-friendly applications or service providers, is map their financials and other information to the applicable tag.



Why should companies want to do this? Tagging means the opportunity to make reporting easier, cheaper, and more powerful as a communications tool.

- Tagging eases reporting now and in the future because it isagnostic with respect to technology or its age. In short, it is interoperable. XBRL tags, as a standard, provide the means for financial managers to cut across systems now or as they might be changed, and work as effectively on laptops as they would on big-time ERP systems. In fact, accounting systems large and small have already built in XBRL tagging.

- XBRL seems like it must be a huge and expensive commitment, but it is usually inexpensive to implement and maintain, with the prospect of outright savings even immediately. Start up outlays can be as little as several thousand dollars, and the first tagging run can take some effort. But especially for mid-and small-sized companies, the effort can reduce financial consolidation costs from disparate operations right away, and even more in subsequent periods. Fixed, standard tags improve

consistency and reduce risk. Again, this might seem counterintuitive, but it is real.

- Companies can and already use XBRL to improve their communications to investors. Not only does it save investors time, it meaningfully enhances their ability to do the analysis they would do anyway. And by taking out the middleman who introduces errors and simplifies financials, issuers can convey their business reporting, as presented by management, straight to the investment community.

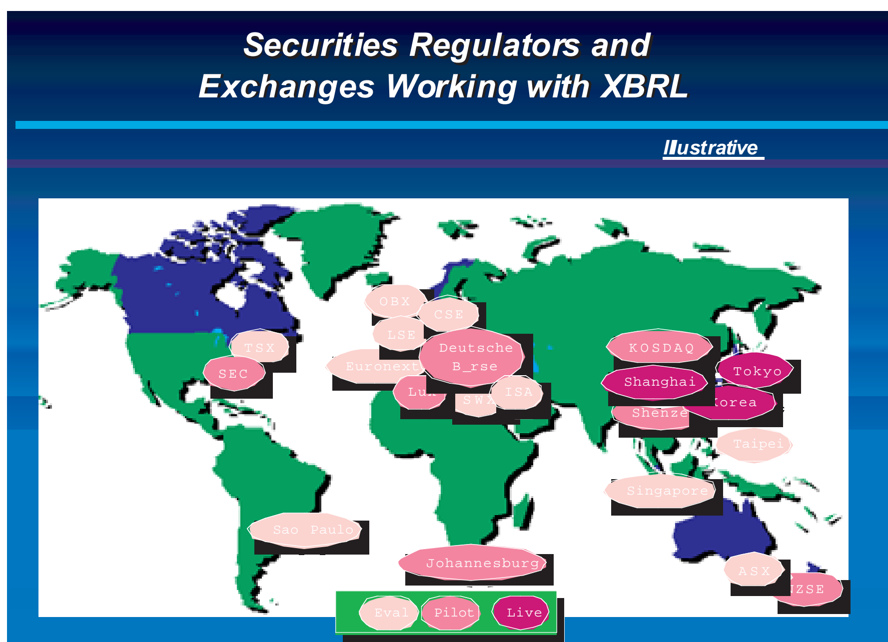
There is nothing novel in the tagging process. The accounting concepts do not change from US GAAP or IFRS, and financial managers do not have to innovate or improvise. In rare instances when a company has a unique or idiosyncratic reporting line, the "extensibility" of XBRL comes into play as the company can create a custom tag. That is the core of XBRL: endowing the stuff of business reporting with identity, with context, and with the potential for intelligence.

Intelligence means power

That potential for intelligence is what made XBRL so compelling to Chairman Cox when he was appointed to the SEC in 2005. Just as there are technologies to help solve the "last mile" problem in building networks, XBRL helps solve the "last mile" problem in financial disclosure by providing the infrastructure for reported data to travel to the investor directly, immediately and effectively. Software is already out there in the US and around the world to enable investors to view and analyze financials nearly simultaneous with their release. And it's easy enough for the retail investor as well as the professional. Go to the SEC's web site and you can already experiment with a couple of these XBRL filings and sense the power. Developers right now are building next-generation tools that will incorporate XBRL rather than relying on traditional, indirect sources.

This "power" for investors derives from several particular attributes of XBRL-tagged data:

- It is the data as released by the company, with no aggregations, standardization or interpretation or abridgement.
- It is available in real-time, ready to import into a spreadsheet or other applications, with the tagged data knowing where to go.
- It is perfect for alerts and automated feeds.
- The content is free, as befits public domain content.
- It can be available for all public filers, not just for some.
- Comparability across companies – all using the same tags - can be nearly automatic.



- And, increasingly as accounting regimes converge, so cancomparability globally. In fact, several financial institutions using XBRL internally, including Wall Street banks, have experienced increased efficiency for their analysts, enabling them to go deeper and cover more companies. These benefits can be realized by all investors.

This is the power – not just tags, but really interactive disclosure – that Chairman Cox and other regulatory and financial markets leaders see in XBRL. It is a useful medium for corporations, but a most powerful and intelligent tool in the hands of the investment community.

What's next?

The future of XBRL, or rather interactive disclosure needs to be viewed on two horizons: the short-run practical, and the longer-run strategic.

Short-run: the implementation of interactive disclosure needs to continue to accelerate. Such markets as the Netherlands and the UK already use XBRL for company disclosures to government, but Japan is mandating XBRL for public disclosures starting in April 2008. Form-based versions also are being mandated in Israel, China and Singapore, among other markets, and XBRL is in evaluation stage in dozens of other jurisdictions fully around the world from Canada to Australia. (See Exhibit 2) In the US, XBRL-US has, under contract to the SEC, released the full taxonomy of US-GAAP for financials and notes for public comment. Based on this and the experiences of the more than 60 voluntary filers during the past two years, the SEC will consider how it might best implement XBRL.

Certainly, for US companies, we encourage them to try out XBRL right now. Visit www.xbrl.us for the materials to understand it and the resources to get started implementing it. Mutual Funds are already beginning to submit their risk and return data through a similar voluntary program, which has exciting prospects for analyzing the more than 8,000 funds more effectively.

Strategically, it comes back to interactive disclosure. As much as through the more-visible international reporting convergence (which itself is heavily enabled by XBRL), it is the convergence between the corporation and the investor that is fostered by endowing business reporting with intelligence. Not only is the temporal separation between corporate managements and investors eliminated by real-time availability, but so can other factors that separate the two. New kinds of voluntary disclosures become possible, as well as new analysis. Data immediacy is valuable in its own right, but imagine how tagged financials might facilitate analysis by "mashing" financials up against sustainability, geographic operations, corporate responsibility, or compensation data? In fact, taxonomies for all of these aspects either exist or are being developed – by private sector initiatives! Just as new types of analysis became possible in the 1930s with the introduction of regular reporting, interactive disclosure should have a transformative influence on how companies are analyzed. As an example, there are SEC forms that are already in the public domain that are not easily available – some still paper-based. These can and should be XBRL-enabled to make them easier to submit, and easier for investors to access and use for novel and better analysis.

It is increasingly clear that interactive disclosure brings ever closer a more efficient, information-driven, and investor-enabled market – and mostly through private sector initiatives and innovation.

Some observers speculate further – and there are some exciting possible futures – but the SEC is focused on laying the groundwork. Chairman Cox created a separate Office of Interactive Disclosure in October 2007 to align current activities and set strategy.

Corporations and investors, and by implication the capital markets generally, all appear likely to be winners in the interactive disclosure future that is now taking shape. ■

Streamlining Business Reporting

Mike Willis is a partner with PricewaterhouseCoopers LLP and was the Founding Chairman of XBRL International and is a Founding Member of the Enhanced Business Reporting Consortium

Why does it take weeks or months for executives to obtain relevant information for operational decisions and/or external reporting? Why are reporting compliance process costs larger than research and development costs? Why is business information provided for analysis in manually prepared spreadsheets and almost always lacking some critical piece of relevant information?

Simple. Because current business reporting processes are largely manual. Once business information is originated, it is repeatedly manually accessed and manually validated. Reports are manually assembled and quality control is manual. Analysis requires significant manual efforts and there is limited sharing of key common terms and/or incremental analytical concepts. Even with incredible advancements in technology business reporting processes have only digitized reports making information more accessible but not more discoverable or reusable. The extensible business reporting language (XBRL) takes business reporting processes fully into an internet-enabled processing environment and the digital networked information age....

By way of an analogy, if cars today were produced like business reports, each vehicle would be custom crafted and assembled by hand. Vehicle costs would be relatively high, quantities low, and the number of options would be very limited.

Why do you know the name of your accounting consolidation software application but not the name of the software application enabling your website? The answer is simple - standards. On the internet, everything is standardized. The internet's universal ubiquity makes possible to use it for a wide range of business processes. On the internet, one can easily access a wide range of content and services provided by an endless number of sources. Internet standards (eg html, xml, url, and others) promulgated by international market consortia, enable an incredibly wide range of software applications to seamlessly exchange information for an ever increasing range of processes.

Why doesn't it work the same way for your business information, business reports and analysis?

Standards for business reporting

The Extensible Business Reporting Language (XBRL[1]) is the international standard specifically designed for business information and related processes. XBRL International is a market consortium effort comprised of over 550 organizations from 27 countries around the world.

The XBRL standard is specifically designed to enhance enterprise business reporting and compliance processes. XBRL enables a standardized description of business information, related references, rules, and contexts so that they can be seamlessly transferred, exchanged, validated, analyzed and rendered across the diverse range of software applications within the business reporting supply chain. This allows for many of the currently manual reporting process steps to be automated and related controls strengthened. What used to take weeks or months can now being accomplished in a matter of seconds.

With respect to external reports, XBRL does not mandate a standard reporting template; rather it provides a standardized manner in which to accurately articulate business information concepts. The XBRL format enables preparers to enhance reporting processes while increasing the reusability and analysis of reported information. XBRL allows companies to quickly and accurately communicate directly with stakeholders over the internet via RSS or web services; "broadcasting" standards while giving consumers the ability to access, validate, consume and analyse business information as soon as it is provided. This is possible as information produced in the XBRL format by one application is immediately consumable and executable by another software application immediately, without manual intervention, validation processes or time.

XBRL dictionaries of common standardized reporting concepts (XBRL Taxonomies) are currently available for a wide range of reporting concepts. Taxonomies provide the structure for commonly reported concepts and can be extended to address company specific unique reporting content (eg business segments, product groups, etc). Taxonomies may be publicly available while others may only be available to a specific group of regulated entities (eg banks or insurance companies regulated by a specific agency). Regulatory specific taxonomies exist for a wide range of purposes from statistical to statutory to anti-money laundering to risk management (BASEL II) and many others. Other more general business reporting market taxonomies exist for US GAAP[2] and IFRS GAAP[3] as well as non-GAAP areas such as sustainability as outlined in the Global Reporting Initiative G3 Framework[4]. Last but certainly not least, the XBRL Global Ledger Taxonomy provides an international standardization model for describing transactions, sub-ledgers, ledgers, general ledgers, and trial balance information. The XBRL Global Ledger Taxonomy is most relevant in addressing internal enterprise compliance and reporting process inefficiencies.

The incremental structure provided by XBRL taxonomies is not limited to only financial reporting concepts. Companies seeking more relevant information about the broader business landscape, their specific market strategies, relevant resources and processes, and performance measurements need additional frameworks and definitions. As a result, several market consortia are currently at work on such incremental frameworks and information concepts including:

- The Enhanced Business Reporting Consortium[5] (EBRC) has developed a broad business information framework designed specifically to address these highly relevant information concepts,
- The Japanese Ministry of Economics, Trade and Industry (METI) is working on KPI's for the automotive and other sectors,
- The Federation of Financial Analysts Societies is working on KPI's for the telecommunications' sector, and
- The Investment Company Institute (ICI) has produced an XBRL Taxonomy for the "Risk and Return" portion of the mutual fund prospectus that has been approved by the US Securities and Exchange Commission for use in the US Capital Markets[6].

The Enhanced Business Reporting 2.0 Framework is outlined on the consortia's website: http://www.ebr360.org and is outlined in Exhibit 1. It incorporates industry-centric measures such as KPIs. This broad conceptual framework also meets unique company-specific reporting requirements via extensions.

The consortia efforts described above provide market evidence of the need for broader frameworks and more relevant conceptual structures to more accurately and completely articulate business information. These frameworks and the resulting taxonomies can be leveraged to further enhance the enterprise and stakeholder business processes.

Enhancing business processes

Standards, particularly those developed by supply chain participants, are specifically designed to enhance business processes, enhance quality and improve precision for all supply chain participants. As a result, adoption of supply chain standards is driven by economic incentives rather than regulatory mandates. For this to happen, all supply chain participants need to understand that adoption benefits include the following:

- Enhancing processes – as with the Universal Product Code or 'bar code', better information structure allows for greater levels of business process automation thereby further lowering costs and increasing quality. ▸▸

EBR Framework Version 2.1*

Enhanced Business Reporting Framework

Business Landscape	Strategy	Resources & Processes	Performance
Business Landscape Summary	Corporate Strategy Summary	Resources & Processes Summary	Performance Summary
Economic	Vision & Mission	Resource Form	GAAP-Based
Industry Analysis	Strengths	- Monetary Capital	GAAP-Derived
Technological Trends	Weaknesses	- Physical Capital	Industry-Based
Political	Opportunities	- Relationship (Social) Capital	Company-Specific
Legal	Threats	- Organizational (Structural) Capital	Capital Market-Based
Environmental	Goals & Objectives	- Human Capital	
Social	Corporate Strategy	Key Processes	
	Business Unit Strategy	- Develop Vision & Strategy	
	Business Portfolio	- Manage Internal Resources	
		- Manage Products & Services	
		- Manage External Relationships	
		- Manage Governance and Risks	

(* An XBRL taxonomy has been developed)

- Enhanced relevance – the extensible information frameworks articulated as XBRL taxonomies provide a standardized platform for the expression of relevant information.

- More pervasive and agile controls – controls and process designs are currently either manual or embedded within the specific software applications. They are typically slow or opaque, and often both. XBRL provides a transparent and executable platform for the articulation of analytics, references, controls and other process design concepts that can be centrally managed and executed across all relevant process applications.

- Greater transparency - greater transparency of both internal and external information is provided by the XBRL taxonomies and structure applied to business information currently resident in a wide range of disparate software applications.

- Increased frequency – when you consider the timing for reuse of current business information, it is measured in hours or days. The speed of access and reuse for XBRL formatted business information is measured in seconds.

- Other - other benefits are outlined at http://www.XBRL.org[7]

Companies have taken different adoption approaches to realizing these benefits. Some companies start at the end of their reporting processes and work back into enterprise compliance processes, while others start inside the company and work towards external reporting. One key adoption principle to consider is that standards-based process improvements can be applied in an incremental fashion. There is no requirement for a 'big bang' adoption approach. Many companies look to the process areas where there is the most 'pain'.

Internal enterprise process improvements are being applied to a wide range of pervasive process problem areas including: poor data quality, manual process steps and audit trails, information aggregation using spreadsheets, weak and inflexible control environments, post merger systems integration, periodic internal audit assessments, etc. Any point along the business reporting supply chain where information is passing between different software applications or is manually processed is a likely candidate. Realized results to date reveal that the standardized approach has a shorter implementation period, is more cost effective than existing solutions and is more agile in dealing with prospective changes.

External reporting process improvements are the likely candidate for initial attention as they are closest to the perceived point of weakness and the pervasively manual nature of these processes is painfully obvious to almost everyone involved. The manual spreadsheet aggregations, manual report preparations, manual quality control steps, and the document centric serial review processes all require time and cost that can be eliminated. United Technologies Corporation (UTX), is leveraging Hyperion Financial Management XBRL capabilities to reduce the time and cost associated with their reporting process by 20% to 25%. Not bad for a company that can already close the books in 48 hours and drill down to any of their 1100 subsidiary transactional ledgers. If UTX can realize this incremental level of cost and time savings in their already world class reporting processes, what is possible elsewhere?

Process improvements are also being realized in the analysis of reported business information as well as enhancing quality assessments on report drafts. The cost of accessing more information is dramatically lowered in the XBRL format. Additionally, the standardized XBRL taxonomies enable standardized analytics that can be shared across spreadsheets and other analytical applications. This transforms the analytical intellectual property currently opaquely embedded within individual spreadsheets into reusable and executable analytics that can be immediately used in other analyst's spreadsheets, just like the MP3 formatted music files are shared and reused in a range of digital players.

There are a wider range of business process enhancements currently available to your organization. Realizing these benefits requires an understanding of how standards can be leveraged to enhance your compliance, reporting and communications processes.

Next steps - what do you do next?

It depends on your goals and objectives. If you are interested in enhancing your compliance and reporting costs, then start with standards-based implementation in your priority pain points (manual aggregations and analysis, data validation, etc). If you are interested in enhancing the reusability of your reported information, then transition external reporting formats to XBRL. If you are interested in enhancing the reuse of reported information AND enhancing its relevance, then engage in the relevant market and industry consortia such as those mentioned above. This includes broad market frameworks such as the Enhanced Business Reporting Consortia and more industry-specific efforts directly relevant to your company.

Bottom line, streamlining business reporting is a supply chain effort and it begins with you. ■

1. *http://www.xbrl.org*
2. *http://www.xbrl.org/us/taxonomies/*
3. *http://www.iasb.org/xbrl/index.html*
4. *http://www.globalreporting.org/ReportingFramework/G3Guidelines/XBRL/*
5. *http://www.ebr360.org*
6. *http://www.sec.gov/news/press/2007/2007-134.htm*
7. *See the XBRL Business Benefits: http://www.xbrl.org/XBRLandBusiness/*

Meeting the Needs of the Global Payments Industry

Dave Hunkele is VP Global Product Management, Financial Services, at Sterling Commerce

Disruptive global forces are impacting the business of payments, and as a result of these forces, both threats and opportunities have emerged.

The global payments industry is in a period of extraordinary transformation. As financial institutions react to the unsettling forces impacting their businesses, new opportunities emerge for those broadening their focus beyond pure cost cutting and compliance, to a more inclusive view centred on revenue growth, operating efficiency, and improved customer service.

Adapting to legislated changes

In the United States, a 10+ year movement toward image enablement and the legislative push that Check 21 provided clearly benefited all participants impacted by the high cost of check handling and processing. Now, with electronic payment volumes surpassing checks for the first time in 2007, new opportunities emerge for those institutions looking to move beyond eliminating cost, maintaining competitive equality, or simply surviving.

While the short-term opportunity for the remaining large check processors might be in-sourcing to make the most of excess capacity, a better strategy might be one that focuses on how to retire checks once and for all. For consumers, this means enabling the ubiquity of card solutions, and proliferation of simple electronic payment alternatives. However another motivation or incentive may be required to give consumers a reason to stop writing checks.

Conversely, for businesses, eliminating the checking status quo, means addressing the real reason why corporate checks continue to be the largest contributor to the remaining check volume. The idea exists to provide an electronic offering that doesn't require businesses to totally restructure their payables and receivables processes; and that enables high value payments, purchase orders, and invoices, to flow seamlessly through clearing and settlement systems. Once adoption reaches critical mass, and all prior objections have been addressed, the true benefits of adapting to Check 21 can be realized.

The impact of legislated changes in the payments industry is also having an impact in Europe. The drive toward expedited settlement with faster payments in the United Kingdom, and the focus on replacing expensive cross-border payments with SEPA direct debits and credit transfers, have imposed a heavy burden on Europe's financial institutions. These institutions grapple with the simultaneous demands of increasing investment in payments infrastructure, a rising emphasis on conversion activities, mounting compliance mandates, and the re-aligning of their businesses to overcome the negative impact that these initiatives have on fee income revenue.

Ultimately, the participants must question when critical mass will be achieved with SEPA, and when the legacy local payment solutions for high and low-value payments will be retired. Without an end date in sight, the magnitude of the payments problem will continue to expand.

Adaptation in this dynamic environment requires financial institutions to take a fresh look at the available alternatives — including implementing more open payment solutions that break down the barriers created by decades of operating in silos, and outsourcing processes that are deemed to be true commodities.

Assessing the impact of risk and compliance on R&D

In the past year, a number of global financial institutions have made headlines due to material shortcomings related to their anti-money laundering controls; they were penalized in the form of heavy fines, and cease and desist orders. Perhaps the greatest fear to the financial institution community is the fear of damage to the franchise and brand.

Yesterday's research and development investment is now consumed by increasing compliance and monitoring requirements — as much as 30% of the investment, according to the *World Payments Report* published in 2007 by CapGemini, ABN AMRO, and the European Financial Management and Marketing Association[1].

KPMG tracked a 71% increase in compliance costs for North American banks over the past 3 years—far surpassing the cost of compliance for institutions outside of North America[2].

The focus on managing risk and fraud prevention has highlighted the need for many financial institutions to renew their commitment to improve overall business intelligence. This commitment becomes increasingly more difficult given the complexity of the payments infrastructure, yet new areas of technology exploration in the field of data virtualization, make achieving this goal conceivable.

Institutions that have invested in building the proper controls and monitoring capabilities, and are rigorous in their efforts to validate their effectiveness, are the institutions that will ultimately survive this disruptive force.

Addressing the commoditization of payments and the drive for operating efficiency

As electronic payment volumes continue to increase, the pressure to process payments more efficiently grows, and payment pricing loses its elasticity. While financial institutions look to expand into large growth or underserved markets, such as the SMB payments market, they must find a way to address the efficiency of their payment operation if they expect to provide competitive solutions across all customer segments. This fact mandates the need for financial institutions to realize their maximum potential, as it relates to the elimination of manual processing steps, and the adoption of straight through processing (STP) solutions.

For years, payment originators have asked their financial institutions for a simpler way to initiate payments. The commoditization of payments, coupled with the increase in payment offerings, and payment channels may provide the final impetus for change. It may allow the payment originator to simply ask for a payment to be made to their intended recipient by a certain date from wherever they are. The questions of currency, when value needs to transfer, and which payment format will be used are best addressed by the financial institution. The payment originator is best serviced when insulated from these issues.

As batch-oriented payment systems continue to improve the timeliness of payment processing at a low cost, financial institutions will need to adapt with effectively priced payment solutions providing alternative and cost-effective routing options. Expect to see customer demands for lower cost and best methods routing alternatives increase. Also, expect to see a shift in multi-currency payment volumes from high-cost payment methods to lower cost choices.

Acknowledging the complexity of the payments infrastructure

The complexity of the payments infrastructure cannot be overstated and is the result of significant business, technological and societal trends that have occurred over the last 20 years:

- M&A activity
- Technology advances and transformation
- Information availability
- Geographic reach
- Delivery channel expansion
- Increased number of participants in the payments process
- Difficulty decommissioning old payment solutions and supporting infrastructure
- Steady introduction of new payment standards and options

The payments infrastructure is commonly the target of significant ongoing investment. The complexity of this environment has created the undesired side effects of having to operate in processing silos, and produced an inability to serve customers in a transparent manner. ▸▸

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Trading in the off exchange retail foreign currency market is one of the riskiest forms of investment available in the financial markets and suitable for sophisticated individuals and institutions. The possibility exists that you could sustain a substantial loss of funds and therefore you should not invest money that you cannot afford to lose.

To simplify this complexity over time, financial institutions must evaluate open solutions that promote maximum leverage of existing infrastructure investments, and increase customer service transparency.

Moving beyond the disruptive forces

The disruptive forces impacting the global payments industry require financial institutions to carefully consider both the threats and the opportunities that are being created. By providing equal attention to the opportunities and the threats, institutions will be well positioned to benefit in the face of many new forces certain to disrupt their business in the future. ■

1. *World Payments Report – CapGemini, ABN AMRO and European Financial Management & Marketing Association, 2007*

2. *"North American banks' compliance costs have skyrocketed 71% during the past three years, outpacing the increases at banks in the rest of the world, according to a survey by KPMG's forensic practice." – American Banker, 7/10/07*

Automated Trading

Marilyn McDonald is the Marketing Director for Interbank FX. She is also a trader and the author of *Forex Simplified*

Any trader who is even remotely familiar with retail foreign exchange knows what an extremely volatile market it is. This year alone international currencies have fluctuated wildly, with the dollar reaching decade, and in some cases even all-time, lows. Within the forex market realm, however, volatility often creates opportunity. And because forex is open for trading 24 hours a day, five-and-a-half days a week, it is nearly impossible for any one trader to take full advantage of every opportunity that arises during market hours. As a consequence of this growing desire to trade around the clock, automated trading has piqued market-wide interest and completely changed the face of forex trading.

Automated trading, or algorithmic trading is using computer programs to generate nearly instantaneous buy and sell orders. This type of trading has been leveraged heavily by institutional traders and is now gaining popularity in the retail sector, particularly in the forex market. Algorithmic trading accounts for a third of all share trades in America and the Aite Group, a Boston-based consultancy group, thinks it will make up more than half the share volumes and a fifth of options trades by 2010.

There is little doubt that in recent years automated FX trading has exponentially increased in both corporate and retail arbitrage strategies throughout the world. And as demand for better execution performance and reduced latency continues to grow, automated trading becomes increasingly more embedded as a key tool for the successful forex trader.

Whether you are active in the FX arena or new to this dynamic sector, you will most certainly have come across the three following idioms: Don't allow greed and fear to cloud your trades; always set a stop loss and profit objective; and execute trades quickly. Using an automated trading system fills each of these requirements and has the added benefit of being able to trade around the clock in this 24-hour-a-day market.

When considering an automated trading system, it is essential to bear all of these in mind. Take the time to think through your system carefully. Considering all of the possible outcomes is key to the best possible system. Keep in mind that your system won't make adjustments for market volatility, nor will it take every eventuality into consideration unless you have already thought through every conceivable scenario and made the appropriate modifications. What's more, a well thought out system will not modify a stop loss because it believes the market will rebound, nor will it modify the profit target of a trade because it suddenly thinks it can make more money. The program won't second guess itself and the execution is performed within seconds — it sees a signal and it places the trade.

If you have been in the forex game for any length of time, you have most certainly spent countless restless nights worrying about that one trade that will either bring you riches or flatline your account. An automated system eliminates the problem of emotional overload and gives you peace of mind knowing that your program can identify trading opportunities, set trailing stops, and profit targets. No more late nights spent worrying about your trades.

Which brings up yet another advantage of automated trading — your ability to trade while away from your desk. An effective strategy could trigger a myriad of signals and create profit during times at which you have previously been unable to trade. The average "nine-to-fiver" is no longer limited by time constraints.

Greater diversification is yet another fascinating aspect of employing a computer in your trading. Automated trading now allows one single trader the ability to trade in different markets and different time zones simultaneously. A system can be programmed to analyze short-term data and scan for opportunities on any and all available currency pairs and periodicities, essentially eliminating the need to open 15 charts to ensure you don't miss out on a good trade. An effective program can make certain that you see any available opportunity and execute the trades accordingly.

So the question that begs to be answered is how does one develop an effective automated trading strategy? Well, you need to consider the issue from three different perspectives; as a trader, as a programmer, and as a technology specialist.

As the trader you must be able to clearly specify your trading behavior across all of your chosen currency pairs, in all different market conditions, and in all applicable time frames. This is what I consider to be the major stumbling block for retail level forex traders that are becoming interested in automated trading. It is one thing to look at your charts with all of your indicators and make trading decisions. It is quite another to write down the rules of your systems and only trade by those rules. You may be making considerations that you can't even pin point. You can't program a system to look at generalities, you must make specific rules that you never violate. A good start is to keep a notebook next to your trading platform and record exactly why you buy and sell. This is an important part of the process that many gloss over and then wonder why their system doesn't perform as they think it should.

The technology specialist in you has already selected a trading platform. However prior to building your system it is not a bad idea to look around at all the offering and make sure that you using the best technology for your objectives. There exists today a myriad of popular platforms — including several that are free of charge — provided by a number of forex brokers for development and back testing. Consequently, it is now possible for the retail investor to start trading on a variety of platforms that were once available only to large financial institutions.

Once you can clearly identify your trading behaviour you can begin the programming process. This can either be done by the trader or done as work for hire. There is an entire cottage industry that has sprung up around automated trading for the retail trader. Make sure that your system is clearly defined before starting the programming process. Without this foundation, the project will only end in tears. If you choose to program your own system it is wise to look for a broker or platform that offers a full function library of basic systems.

Automated trading for the retail forex trader is really in its infancy and while this segment of the market is poised to grow substantially over the next few years only the prepared will be able to take full advantage of the full offering. If this happens to be an area that you are interested in I would suggest taking full advantage of all of the information available on this subject, perhaps even studying the algorithmic trading systems of other securities industries. This will give you the greatest insight into what needs to be considered when creating your own strategies. ■

Bricks v Brains

Rod Taylor is Head of Hospitality & Tourism at Europe Arab Bank plc

Bricks v Brains. If anyone could prove without doubt that they came up with this phrase, they could probably dine out on it for free for the rest of their lives!

But where did the phrase come from and why! Historically hotels and many other property assets were both owned and operated by the same entity. The introduction of the concept now accepted as "PropCo" and the "OpCo", the "bricks and brains", was an attempt to divide the two distinct areas that make up most property based asset, ensuring that maximum value was generated from each. Just as the phraseology suggests, the PropCo owned the "bricks" with the OpCo looking after the operational aspects and were thereby christened the "brains".

Some might say that "innovation" was at the heart of the phenomena, others might suggest that it was Marriott and subsequently Host that prompted the wider change. Others might consider it was a natural market progression or that the prime mover was greed. What I think is beyond doubt is that the publicly quoted companies that first embraced the idea were driven to do so by institutional analysts whose job it is to comment on how well a company is performing and recommending investors to invest, hold or sell stock. For the hotel industry some five or six years ago, this pressure grew as analysts pushed boards to sell assets, reduce capital intensiveness, exit property investment, focus on brand management and return cash to investors. The argument was that a new breed of specialist property owners could make a better fist of generating income from these fixed assets than the hotel company had done.

Some companies brought into this premise quite quickly, some initially argued to the contrary and others sought an "asset light" or "asset right" strategy. But ultimately pretty much everyone of size has, with the exception of Whitbread and thereby Premier Inn, fallen in line. Isn't it an amazing marketplace where institutional analysts, some just out of business school, probably never having done more than read in their text books about a "recession" have still fundamentally changed the face of property?

Its also true to suggest that there's probably no going back although I've recently heard mutterings that suggest if property prices really were to fall heavily in the future, then opportunistic acquiring by the "brands" might occur. After all, we regularly remind ourselves that we are a cyclical industry. However to be frank, I don't subscribe to heavily falling prices and so the opportunity is unlikely to materialise.

A central question in the Bricks v Brains, PropCo v OpCo debate is - are these institutional analysts in the future going to be sitting across dinner tables suggesting "I fundamentally changed the hotels property market", or will it be something best forgotten! My view is that their initial premise, that they could unlock shareholder value, has proven to be a valid one; albeit it might prove to be a one hit wonder. The value of hotels had at the time been rising, the industry was viewed as opportunistic by investors, yields vis-à-vis other property classes looked attractive and so money flooded into the sector and the hotel companies or, more precisely, their shareholders benefited. Short term that is!

This phenomenon has brought new investors into the hotel industry and generally speaking, at least for those who invested early, values did rise and happiness prevailed.

These "new to market" investors who were not "dyed in the wool" hoteliers have also brought about the development of the new breed of asset management companies who work on behalf of the investor to keep the newly installed "brand owner" on their toes. Because canny investors realise that market sentiment can influence yields and thereby values, they have quite rightly pressed their asset management company to extract maximum cash flow. So the investor is the "bricks" in our equation and the brand is the "brains".

But what of the "brand" owners, the "brains" alluded to in my introduction. Historically portfolio expansion was relatively benign, in part because "hotels" are hugely capital intensive and even a publicly quoted company only has a finite amount of free cash.

Nowadays, post Bricks v Brains, PropCo v OpCo the international brands can have development teams across the world, as investment capital is not an issue as this will be provided by the investment partner.

The "brands" can now, by way of example, consider India, China, Eastern Europe or wherever. They don't even need to source the site; the investor does that for them. Little capital is required, a choice of sites, an expanding pipeline and eventually another name over the door, coupled with semi guaranteed medium term cash flows for the "brains" - Heaven personified? But, I'm a banker so I have to introduce a "but" at this point. So, "but" we should be asking what happens to the "brains" or let's keep it simple and refer to them as the "brands" when all the choice sites have gone. How many Inter Continentals will be needed in India? How many Marriott's in China? How many Sofitels in the Czech Republic? We are obviously many years away from saturation but at sometime in the future it will come.

Has "asset light" helped to develop the marketplace in the construction of hotels - well, yes! A prospective owner in, let's say Libya would not in the past have found it easy to obtain development finance but now, with Inter-Continental, Marriott or Sofitel et-al entering into a lease or management contract then all is possible. It might also be true to suggest that had these brand owners been asked in the past to put their investment capital into the same hotel in Tripoli then it might not have been built or at least it is unlikely it would have been at the top of their agenda.

There is an old maxim about bankers giving you an umbrella when the sun shines and taking it away when it rains. In many ways that's like trading guarantees by brand owners. They'll guarantee a hotel which is stunningly well sited and avoid doing so in uncertain locations. Am I being unfair to bankers, or perhaps brand owners or both?

It's true to suggest that many more hotels are now being developed because of PropCo – OpCo structures and thereby a much larger investment pot of money. So I am of the view that Bricks v Brains, PropCo v OpCo has had some positive benefits.

What is my view of the industry from the investors' standpoint, the "bricks" in our equation? This becomes more involved because the hotel industry is just a small element of the wider property marketplace. Hotels have seen values rise but from a starting point of yields being ahead of other sub sectors such as offices, warehouses, retail etc. Hotel yields have come in, it could be suggested to unsustainable levels. Indeed there is some evidence coming through to suggest that yields are softening and values have started to slip. Hotels have benefited from the rush to property but not in isolation, it is not a big enough sub sector to be insulated from the overall marketplace.

So if investors in offices or other core sub sectors get cold feet and yields move out, hotels will follow suit. Rather like my earlier suggestion that some institutional analysts have never lived through a recession, so "new to market" hotel investors have never seen hotel values do anything other than rise. Well.....this isn't strictly so, the investors in the **original** Swallow Hotels concept did experience a downturn in value. It was a cracking idea, as long as the financial balls remained in the air. When the balls did eventually fall to earth it was however found to be a flawed model. The premise behind Swallow was raise some capital, buy some hotels, make modest improvements, throw in a supposed "brand" and enter into an PropCo v OpCo structure. OpCo, the "brains", enters into a lease with PropCo, the "bricks", underpinned by a fixed rent at a level that is unsustainable, and seek to on-sell this investment to less well informed, largely private investors.

The outcome, apparently unexpected trading downturn, means that the **original** Swallow company as the "brains" can't pay the rent and goes into liquidation, investor the "brick" is left with a hotel he has neither the wish nor the experience to manage and when he tries to re-let the property finds the previous rent cannot be replicated as it ▸▸

had been set at too high a level. Result the value of the asset falls – so there have been some historic casualties with Bricks v Brains. The "brand" has of course risen from the ashes, has been acquired by new investors and "new" Swallow appears to be trading well.

What this indicates is that investors would be well advised to only enter into a lease or management contract with a real "brand" that is recognised and admired by the travelling public and is also financially robust.

When the PropCo v OpCo debate first started there was a feeling that a "lease" was safe and sound but a "management" contract was suspect. The lease was good for the owner; the management contract suited the brand owner. But experience has shown that both, and hybrids thereof, have a place in the investment marketplace. Management contracts need previous, internal experience or brought in knowledge. Otherwise you'll hear the plaintive cry of "this is our standard contract" from the brand owner. Both sides should get a fair deal, a win/win and having an experienced lawyer and a team of professionals steeped in the property industry on your side is a big plus. Being able to say with conviction "you don't really mean that do you" is an art and could save "bricks" a lot of heartache throughout the term of the contract.

For the "Bricks v Brains" partnership to work long term there must be a shared vision and strategy for the asset.

I've considered the thinking behind "Bricks v Brains", have reviewed the development of new hotels, evaluated the investment barrier and all that remains is to consider "How are the operators, the "brains" shaping up"? Well, Operators/Brands/Brains – they're actually doing rather well in terms of both income and thereby cash generation from the base fees, incentive fees, marketing fees, advertising fees etc being charged to "bricks". Here I'd also like to add a plaudit for the new asset management companies whom I suggest have helped drive the "brains" to even greater levels of operating efficiency. The PropCo v OpCo, Bricks v Brains structure has minimised risk for OpCo's, the "brains" and has as a result generally stabilised their income levels, with increasing profits emanating from their growing, world-wide portfolios. But while I do suggest that OpCo's might now be sitting pretty, with their growing number of management contracts, what then is the outlook for the "bricks"? It's great to have new investors, new money coming into any sector, but my primary concern revolves around what happens if property yields soften and move out, values fall and some investors experience burnt fingers. If there is such an effect on the wider property sector, which there currently is, then the hotel sub sector could experience a similar downturn.

To summarise:-

1. Has Bricks v Brains returned cash to shareholders locked into previously average performing hotel stocks – yes.
2. Has it generally helped "brand" owners, the "brains" – yes.
3. Has it helped expand the number of "branded" hotels world-wide – yes and to some limited extent no. Across the UK and other brand conscious European countries like France it has but in Italy, where brand penetration is low, it has had a reduced effect.
4. Have the new breed of investors, the "bricks" benefited from uplift in values – yes, so far.
5. Will "brains" see profits continue to rise in the near future, aided by an expanding pipeline of openings - yes
6. Might "brains" profits plateau as an when the market for new openings is satisfied – yes but we're still a long way off.
7. Should "bricks" be currently looking to invest – yes, but with caution and with a weather eye at what is happening across the wider property sector.
8. So to all these points I have answered "yes."
9. Did I come up with the original "Bricks & Brains" slogan – "no."

A banker always ends with a "no" and I try not to disappoint. ■

OECD Enlargement and Enhanced Engagement: *A Role for Business*

Mark Primmer is the Communications Manager of BIAC, the Business and Advisory Committee to the OECD

For business leaders and public policymakers alike, one of the most important developments in the increasingly globalised world is that the economic inter-dependence among countries world-wide has deepened to such an extent that all economies – both developed and developing alike – are affected by the policies made by global decision-making bodies. Two decisions, one by the OECD and the other by the G8, confirm the significance of this point.

On May 16, 2007, the OECD Ministerial Council[1] decided to invite Chile, Estonia, Israel, Russia and Slovenia to open negotiations for membership to the OECD. The Ministerial Council also decided to strengthen its relationship with Brazil, China, India, Indonesia and South Africa through a process of enhanced engagement with a view to possible membership.

The following month, at the G8 Summit held at Heiligendamm on 5-7 June 2007, the German government invited Brazil, China, India, Mexico and South Africa to discuss global challenges. The G8 agreed, recognizing its responsibilities and the need to develop common solutions, to create a new framework to engage in dialogue with the leaders of these five countries on such policy areas as promoting and protecting innovation, freedom of investment, development with special regard to Africa and improving energy efficiency (called the Heiligendamm process).

These decisions made by the OECD and the G8 are based on the clear recognition that neither the OECD nor the G8 countries can decide alone on important global policy issues such as trade, cross border investment or climate change without involving major emerging economies.

Strategic milestone

The Ministerial Council's decision on Enlargement and Enhancement Engagement represents one of the most important strategic milestones in the OECD's 45-years history in fulfilling its objectives and maintaining its relevance. These two initiatives will bring economic policy standards of emerging economies closer to those of the OECD for their mutual benefit. At the same time, the OECD can ensure that its members continue to represent a large part of the world economy in order to remain a global institution in the rapidly changing global arena.

We see today that the economic inter-dependence among the countries world-wide has deepened to such an extent that all economies developed and developing alike have been affected by and no economy can remain free from the policies made by global decision-making bodies.

While the OECD Enlargement involves countries that have expressed their willingness to become members of the Organisation, the Enhanced Engagement is a proposal unilaterally accorded by the OECD to those major emerging economies and therefore it is up to those economies to respond to OECD initiatives.

BIAC[2] welcomes the OECD and G8 decisions which, in the business perspective, will make it possible to establish a more coherent policy and regulatory environment among major economies thereby providing an efficient level playing field to businesses. The OECD Ministerial Council decision, in particular, the decision on enhanced engagement with major emerging economies represents a vital structural reform of the Organisation in the long run, since enhanced engagement envisages future OECD full membership of these major emerging economies.

The OECD enlargement

The OECD has prepared a model, as well as country specific roadmaps,

for accession negotiations for those countries seeking membership. Roadmaps include the issues to be dealt with by the responsible OECD committees[3] when they review the policies of countries seeking accession. OECD committees, such as investment, bribery, governance, environment, competition and employment, will engage in policy dialogues in these areas to support the negotiation process. The candidates will respond to the roadmap presented to them by the OECD, indicating their position with regard to OECD policy instruments such as Convention, Guidelines and others. It will take a few years in some cases and longer for others to complete accession negotiations. Business welcomes the entry of Chile, Estonia, Israel and Slovenia that are relatively small but efficient market economies.

With regards to Russia, while business welcomes the opening of accession discussions of this major economy, it urges the importance of thorough negotiations in light of the OECD's values and standards to reach a mutual understanding between the OECD and Russia, so that the OECD peer learning process can work. Rules of law and free market practices, in particular, involving some cases in the areas of energy and financial sectors in the Russian economy shall be thoroughly discussed as main themes in the negotiation process. The negotiation process with the OECD, therefore, will certainly provide Russia with an opportunity to stimulate review and reform in these policy areas.

It may be inevitable for the OECD Council to engage in political issues such as democracy or human rights which are not subjects of the OECD committees, but are mostly addressed by other international organisations such as the United Nations and the ILO. Business expects the OECD Council to take a pragmatic approach to these issues avoiding politicisation as much as practicable. An accession to the WTO will be a precondition to the OECD accession by Russia.

As negotiation progresses with Russia and other candidates, business urges the OECD to make the negotiation process as transparent as practically possible so that business may understand new policy directions which will have an impact on trade or investment activities in these economies.

Enhanced engagement

It is generally viewed that, whereas accession is an OECD choice, enhanced engagement with major emerging economies is a necessity for the OECD to remain relevant as a global organisation. As the G8 itself admitted at the Heiligendamm summit, a group of advanced countries alone cannot cope with the difficult global issues that have arisen in the world economy. The enhanced engagement is a proposal from the OECD to the five emerging economies. This is a huge project which needs to be tackled over the coming years or decades by the OECD and its partners.

The objective of the project is to bring economic policy standards of the five countries closer to those of the OECD members for their mutual benefit. It is expected that these countries will eventually share similar values with the OECD countries on political, social and economic policy areas. In concrete terms it is expected that the major emerging economies (Brazil, China, India, Indonesia and South Africa) will participate more actively in OECD committees and adhere more to OECD instruments with a view of eventually becoming OECD members.

As the enlargement and enhanced engagement process with the afore-mentioned ten countries makes tangible progress in accordance with the norms of the Organisation, the OECD will be able to address global issues more openly and broadly with its members as well as non-member economies. The process will help countries to identify common issues and to seek for global solutions.

While the OECD carries out accession negotiations with the five countries, the OECD will become instrumental in assisting the G8's Heiligendamm process. This is because the OECD and the IEA[4], its sister organisation, are best situated and well equipped in addressing horizontal global issues, innovation, investment, development and energy efficiency in a more integrated way. BIAC expects a constructive outcome from the dialogue with the emerging economies on the afore-mentioned subjects through the future G8 meetings in Japan in 2008 and Italy in 2009.

Role of business

BIAC's advisory role to the OECD committees and working groups – input into the formation of OECD policy instruments – also supports government implementation efforts by ensuring that the policies and programs are developed realistically in order to function in today's global marketplace. Similarly, business/government dialogue during the accession process and committee reviews can assist the evaluation of a candidate country's willingness and ability to adopt OECD policy instruments by providing market-based feedback.

Engaging the business communities of the Enhanced Engagement countries into the BIAC/OECD process will help to strengthen the respective domestic business voices to support their governments in the OECD dialogues. For BIAC, active participation by business from both member and non-member economies is key to raising the level of our policy dialogues with governments as we collectively face the many challenges of globalisation and economic interdependence. ■

1. *Decision-making power is vested in the OECD Council. It is made up of one representative per member country, plus a representative of the European Commission. The Council meets regularly at the level of permanent representatives to the OECD and decisions are taken by consensus. The Council meets at Ministerial level once a year to discuss key issues and set priorities for OECD work. The work mandated by the Council is carried out by the OECD secretariat.*
2. *The Business and Industry Advisory Committee to the OECD (BIAC), based in Paris, serves as the primary and official voice of business community to the OECD. BIAC comprises the major industrial and employer organisations in the 30 OECD Member nations, along with observers in non-OECD member countries.*
3. *Representatives of the OECD member countries meet in specialised committees to advance ideas and review progress in specific policy areas, such as economics, trade, science, employment, education or financial markets. There are about 200 committees, working groups and expert groups.*
4. *International Energy Agency*

Action on Climate Change: The European Perspective

Stavros Dimas is the European Commissioner for Environment

It is no secret that the fight against climate change must be led by developed countries. As a major player in the developed world, the EU is leading by example, and laying down a marker for the world to follow. The scale of the problem is huge. The IPCC (Intergovernmental Panel on Climate Change) fourth assessment report confirmed that if the most serious climate impacts and a global temperature increase of more than 2°C are to be avoided, global emissions will need to be cut by 50% by 2050 compared to 1990. Europe is aware that the world is watching.

With the emissions reduction targets of the Kyoto Protocol set to expire in 2012, the European Commission has been pushing for new targets to be in place well before that date. On 10 January 2007, as part of a comprehensive package of measures to establish a new integrated climate and energy policy for Europe, it launched a strategic policy document entitled "Limiting Global Climate Change to 2° Celsius – the way ahead for 2020 and beyond", which included a proposal for an international agreement to reduce the emissions of developed countries by 30% by 2020.

At the Spring Council of 2007, European Heads of State endorsed the Commission's integrated climate and energy package, backing the aim to reduce global greenhouse gas (GHG) emissions by 30% by 2020. Furthermore the EU Heads of State committed the EU independently to reduce GHG emissions by at least 20% in any event – even in the absence of an international agreement – and backed the development of energy-efficient low greenhouse gas technologies, renewables and carbon capture and storage. Other targets agreed include a target share of 20% for renewable energy by 2020 and a 20% improvement in energy efficiency by the same date.

This independent commitment to action will enable us to kick-start real negotiations and encourage commitments from others. It sends a clear signal about how seriously we are taking the planet's future, and we hope that it will usher in an international regime after 2012 that brings deep reductions from major emitters, including greater efforts by emerging economies.

Early action will bring numerous rewards, and not only for the environment. Business, industry and the carbon markets all need certainty before they can make investment decisions. Energy efficiency will bring higher productivity, and new markets will bring new jobs. European Union companies can take the lead while our universities and the European Institute of Technology can demonstrate our research capability. Pushing ahead with energy efficiency will make our industry more competitive and enhance the EU's energy security.

The Commission is currently preparing the related implementation package to translate the agreed targets into legislative proposals, and these should be adopted by early 2008.

Progress has been made under the Kyoto Protocol. Under its terms, the European Community agreed to reduce its greenhouse gas emissions by 8% by 2008-12 compared to base year levels. Based on the latest available inventory data of 2005, total GHG emissions in the EU-15 were 2% below base year emissions without Land Use, Land Use Change and Forestry (LULUCF). In 2005, EU-15 GHG emissions decreased by 0.8% compared to 2004 while the EU-15 economy grew by 1.6%. Total EU-27 GHG emissions were, in 2005, 11% below the base year level, a decrease of 0.7% compared to 2004, while the EU-27 economy grew by 1.8%.

The signs are that the EU will reach its Kyoto target, provided Member States put their planned policies in place and ensure they are genuinely operational. The recent decisions on the National Allocation Plans under the EU Emissions Trading Scheme for the period 2008-2012 are a big step in the right direction.

The European Union Greenhouse Gas Emissions Trading Scheme (EU ETS) is the largest multi-country, multi-sector greenhouse gas emission trading scheme in the world. It has been in operation since January 2005. The thinking behind it is that markets have little incentive to invest in new low-emission technologies if there is no value in reducing greenhouse gas emissions. Putting a price on carbon sends a signal to the whole economy that the time has come to invest in low-carbon technologies. But just pushing technologies by subsidising research will not ensure that technologies are taken up and pulled onto markets thereby reaching economies of scale. We need emissions trading schemes to do this, while leaving companies the flexibility to decide on how emission reductions can be made most efficiently. Taxation and regulation do not allow this latitude.

Emissions trading systems are therefore the best way to reduce emissions cheaply for many sectors. We expect the ETS to enable the EU to meet its Kyoto targets at half the price it would otherwise have cost. The approved cap for sectors participating in the ETS for the period 2008-2012 is 6.5% below the 2005 verified emissions. This ensures that the reductions in emissions will be genuine. The ETS represents a vital contribution to EU efforts to reduce emissions and will continue beyond 2012.

Leadership also means not shying away from tough issues. The EU ETS is currently under review, and the Commission will come forward with proposals to develop it further for the years that follow the 2008-2012 trading period. Industry is calling for a more transparent and harmonised method of allocation across the EU. We also need to look into increasing the share of auctioned allowances in the scheme.

A number of related proposals are also in preparation. These include legal frameworks for carbon capture and storage and renewables, a legal proposal on setting standards on CO_2 emissions from cars and several specific measures to improve the performance requirements and energy efficiency standards of energy-using products like lighting and electrical appliances.

Aircraft emissions are a tough issue in the fight against climate change. EU emissions from this sector have grown by a massive 87% since 1990. A decade of discussions has failed to provide any effective global action capable of delivering the necessary reductions.

If emissions are to fall, all sectors must make a proportionate contribution, and this includes aviation, where emissions are expected to continue to rise. The Commission has proposed including aviation in the ETS, and this is now being examined by the European Parliament and Council. The proposal is intended to create a level playing-field for all airlines operating in the EU and to cap the emissions from this sector at 2005 levels. The scheme would provide a flexible, market-based and cost-effective approach in line with the EU's general reliance on the global carbon market.

Here the EU is showing the leadership that ICAO, the International Civil Aviation Organization, has singularly failed to provide. The recent ICAO assembly showed that most countries have not yet realized the potential benefits of such an approach. The EU legislative process will ultimately set up a scheme that shows that it can work, and the result will be an inspirational model for the international community.

The EU is also showing leadership in working with developing countries, and has introduced two new financing instruments to help fund cooperation in the area of climate change and energy efficiency.

On 18 September the Commission adopted a Communication on building a global climate change alliance with developing countries most vulnerable to climate change, particularly the Least Developed Countries and Small Island Developing States.

The aims of the alliance are twofold. It will deepen our dialogue with the most vulnerable countries, and it will provide concrete support for adaptation and mitigation measures and for integrating climate change into development strategies. Support is being offered in five priority areas: adaptation to climate change; reducing emissions from deforestation; enhancing participation in the global carbon market through the Clean Development Mechanism; promoting disaster risk reduction, and integrating climate change into poverty reduction efforts. ▸▸

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The results of this dialogue and exchange will feed into the discussions on a post-2012 climate agreement under the UN Climate Change Convention. The alliance will support the converging of visions for the agreement between Europe and developing countries, and particularly the least developed and most vulnerable.

The Commission is setting itself the wider target of integrating climate change into all country and regional strategies by the start of the next programming cycle, which begins in 2014, and encouraging Member States to do the same.

The Commission has allocated an additional €50 million to get the alliance up and running. Taken together with existing EC funding for climate-related activities, the alliance will therefore benefit from some €300 million over the period 2008-10. While this is a solid start, substantially more resources will be required to respond adequately to needs. The Commission is therefore asking Member States to dedicate part of their commitment to increasing Official Development Assistance to this alliance, and above all to create a mechanism to ensure that funds reach the areas where they are most needed as rapidly as possible.

Another concrete and innovative financing instrument in the area of climate change is the Global Energy Efficiency and Renewable Energy Fund. This fund will invest in regional sub-funds in developing countries and economies in transition, providing risk capital for energy efficiency and renewable energy project developers and companies. Public money will be used to buffer risks and attract private investors into the fund.

This will involve a Commission contribution of €80 million over the next four years, bolstering a public-private partnership that could ultimately mobilise over €1 billion. This implies a leverage factor of more than 12, which is considerably higher than for conventional grant-based support schemes that ask for co-funding in the range of 50–70%. Several Member States and European and International Finance Institutions are considering participation.

Successful climate policy is a matter of creating a strategy for the global transition to low-carbon-economies. Negotiations around the post-2012 climate agreement began in Bali. The aim is that the "Bali Roadmap" will culminate in a fair and comprehensive post-2012 climate change framework to be completed in 2009, and which includes all necessary components of a strategy to meet the 2°C challenge.

Emissions trends must be slowed and ultimately reversed. Any failure to limit global mean temperature increases to 2°C above pre-industrial levels will considerably increase the impact of climate change, bringing not only costly adaptation needs but also an unacceptably high risk of large-scale irreversible effects. The adaptive capacity of many systems will be exceeded if temperatures rise by more than 2ºC, with consequences we are unable to predict.

Firm leadership from all industrialised countries – including the United States – is needed, and this has to involve ambitious binding targets if we want to apply the most efficient tools. Contributions will also be required from developing countries, and in particular from emerging economies. It will be vital for us to support their efforts to reduce the intensity of emissions arising from the speed of their economic growth.

Emissions trading and a global carbon market have a fundamental role to play in such a global framework, for the simple reason that they are cost-effective. Cost-efficiency simply requires trading. That is why binding targets are so important – markets do not work without scarcity and legal certainty.

We often hear that there is no magic formula for reducing emissions. But the corollary is that we cannot afford to ignore sectors where emissions are high or rising rapidly. Most importantly, emissions from deforestation, especially in developing countries, and emissions from international air and maritime transport, need to be addressed by the post-2012 agreement.

One significant breakthrough in Bali was an agreement to step up the rate of technology transfer and provide the private sector with more incentives to give poor countries access to the latest innovations, to enable them to make their own contribution to the fight against climate change. ■

Fiscal Policy Instruments and Climate Change

Takatoshi Kato, Deputy Managing Director of the International Monetary Fund

We at the IMF very much welcome efforts to promote dialogue among Ministers of Finance: their active participation and cooperation is essential to deliver efficient and equitable responses to climate change.[1]

Fiscal instruments, affecting both revenue and expenditure, have a central — indeed indispensable — role to play in mitigating against, and adapting to, climate change. They cannot provide a complete solution: but taxes and public spending are key to getting the incentives right for households and firms, as well as ensuring a fair distribution of the associated costs and benefits. Let me elaborate on some of the options and choices available.

Emissions of greenhouse gases impose external costs on the global economy and on future generations — arising from long-term climate degradation and changes in the severity, and possibly frequency, of extreme weather events. The extent of these costs, and those arising from any policy response, remain uncertain. But climate change poses significant macroeconomic challenges for many countries, including many of the most vulnerable. Efficient fiscal policies can help minimize its negative effects.

In relation to mitigation — by which I mean reducing the extent of climate change by lowering greenhouse gas emissions — I would like to stress two points. First, it is essential that effective carbon-pricing policies are implemented, so as to create incentives to reduce greenhouse gas emissions. Here there are a range of policy options available, including carbon taxes, on the one hand, and systems of tradable permits — which give firms the right to emit, up to some fixed amount — on the other. I need not dwell here on the many technical issues that arise in choosing instruments to control emissions — the macroeconomic and fiscal aspects are currently the subject of work at the Fund. What is key is that while there are important differences between them, both methods go to the core of the issue: they can provide strong and credible incentives to reduce emissions and develop alternative technologies.

Second, we need to be sensitive to the distributional impact of carbon-pricing measures — both across and within countries, as well as between generations. However, we must do so in ways that do not undermine the goal of mitigating climate change efficiently. The fact is that in order to reduce emissions the prices of carbon intensive energy sources have to rise, so that we can begin to substitute away from them. Thus it is important, for example, to eliminate subsidies for fossil fuel use, where possible, in favour of measures that more closely target those least able to cope with higher energy prices. Proper energy pricing has long been a concern at the Fund, and climate change lends additional urgency to this focus.

In relation to adaptation, by which I mean actions to reduce the adverse impact of climate change, I would also like to make two points. First, public spending has an important role to play in encouraging households and firms to increase their own resilience, for example through public expenditure on providing the information necessary to make appropriate economic decisions. In addition, it can help reduce countries' risk exposure directly, for example by providing public goods and services, such as infrastructure, coastal protection, education, health and water services, which are themselves more resilient to the impacts of climate change. Importantly, efficient spending on such items may require cooperation at local, regional or global levels.

We should recognize that much adaptation can be achieved in the context of pursuing wider development objectives — for example, improved health and education services. Nevertheless, in some circumstances, adapting to climate change and damages from extreme weather events is likely to impose significant additional costs, not least in the most exposed countries within the developing

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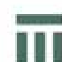


world. There is a clear need for more investment to promote resilience. Thus we welcome efforts to respond to this challenge in an efficient and equitable way, including through the proposed UN adaptation fund.

The range of — and potential for — fiscal measures to respond to the challenge of climate change is wide. And the issues relating to their design and implementation are complex: as are their macroeconomic implications. We at the Fund are currently looking at this, and will be publishing results in our Spring 2008 World Economic Outlook. More generally, we stand ready to cooperate with other international institutions in further studying the macro economic and fiscal implications of — and appropriate responses to — climate change. ■

1. *Based on a presentation by Takatoshi Kato at the Finance Ministers Meeting in Bali, Indonesia, December 11, 2007*

Energy Efficiency Is a Pillar of Sustainable Economic Growth

Carlos Busquets is the Policy Manager, Environment and Energy, at the International Chamber of Commerce

To help meet the world's expected ramp-up in demand for energy, greater energy efficiency will be absolutely fundamental, and must become a higher priority for government, policymakers and consumers than it is today.

Energy efficiency has multiple benefits for the world economy. It reduces costs, since energy is an essential input. It reduces emissions and other environmental effects. It increases the productivity of conventional energy sources. It makes energy more affordable to consumers, not only by curbing energy use but also by reducing the need for large capital investments to boost energy supply, crucial for developing countries to deliver affordable modern energy to further development. Energy efficiency also improves competitiveness and overall productivity, with consequent benefits for the global economy.

World business has extensive experience in how to select and put in place cost-effective ways to save energy. As suppliers and consumers of energy all over the world, members of the International Chamber of Commerce have a wealth of experience to share as innovators of energy efficiency strategies. One case in point: many companies have put in place energy management systems. These systems have led to significant improvements in energy efficiency and generated impressive financial returns. Energy monitoring programs are a way to continuously evaluate and improve use and efficiency of energy, and to help integrate energy into decisions on investment and operations.

Energy efficiency can also play a role in reconciling increasing demand for energy with reducing greenhouse gas emissions (GHG). If it is part and parcel of the planning for new buildings and infrastructure, energy efficiency measures can help moderate rises in emissions while meeting demand for air conditioning.

Also to help meet the 21st century's rising demand for energy, ambitious programs in research and development on energy efficiency will be needed. To continue evolving towards a more productive, lower carbon economy, co-generation, which puts thermal heat to use that is generated during the process of producing electricity rather than wasted, plus other approaches, will boost energy efficiency.

Recent strides have been made by world governments to improve energy intensity, or the amount of energy used per unit of GDP, although there is scope for more efforts. The European Union launched a policy that targets a reduction in energy use by 20% through cost-effective demand and supply-side measures. The G8 group of rich countries has earmarked energy efficiency as an area requiring further action because of its potential to curb greenhouse gas emissions, create jobs and improve health.

At the same time, some European countries have cut taxes on energy-efficient products used in building renovation, while in the US energy efficiency tax credits are given for new and existing homes and commercial buildings.

Making consumers aware of the broader societal benefits of developing more energy-efficient habits needs to be expanded, but a number of programs are already in place. In Europe, an energy-labeling program has led to more energy-efficient products, such as refrigerators and copy machines. In the US, the Energy Hog campaign helps children and parents understand the wider impact of using technologies that save energy.

Cooperation between the public and private sectors has proven to be a successful way to implement energy efficiency initiatives. ICC has also identified policies, many of which involve public-private collaboration, to boost energy efficiency. Advanced technology development on a global scale, through voluntary initiatives and market-oriented measures, with government support for research and development, is a way to develop new cost-effective technologies across sectors.

Opportunities are vast to improve current proven technologies, although more effort is required to transfer these technologies to the developing world and to provide broader markets for innovation of these technologies. The Asia-Pacific Partnership on Clean Development and Climate is an example of attempts to improve technology transfer.

Voluntary initiatives exist in several corners of the world that offer the necessary on-the-ground flexibility to local requirements. A voluntary agreement between the Finnish Ministry of Trade and Industry and energy and industrial countries has been successful during its 10 years in operation. In South Africa, members of the National Business Initiative have signed an Energy Efficiency Accord with the Department of Minerals and Energy. In the US, the Environmental Protection Agency's Climate Leaders Partnership encourages companies to develop long-term and comprehensive strategies to reduce GHGs.

There is also big potential to expand the use of combined heat, cooling and electricity production, a low-carbon process that applies no matter what fuel is used for generation.

To improve and scale up all available and cost-effective efforts to deliver an energy sustainable future, certain principles should be followed. These principles will help further much-needed international cooperation and drive the creation of legal and policy frameworks on energy efficiency: market forces, open trade and investment, mutual recognition of voluntary energy labeling and standards, reliable metrics, and approaches which keep top of mind the life-cycle of products.

These are among the key points ICC is making regularly with policymakers worldwide to encourage wider application of energy efficiency measures. When the UN Framework Convention on Climate Change met in Bali to discuss global frameworks to combat climate change, the ICC was there. ICC discussed technology development and other important solutions, underscoring the major changes businesses have made in how they operate, introducing new processes and providing solutions to the challenge of delivering cleaner energy while addressing climate change, including energy efficiency.

But the solutions do not end here. Energy efficiency must be coupled with a major worldwide attempt to further diversity energy sources. To meet the world's thirst for energy in the 21st century, all energy options must remain open. Because of their cost-effectiveness and supply chain efficiency, fossil fuels will remain a dominant energy source, along with nuclear and hydro, as the world continues to develop wind, solar, biomass, and other renewable sources.

Business is a big supporter of energy efficiency as a part of the solution. Given the right tax and regulatory frameworks business is willing to do much more. ■

Banking on Higher Prices: We See EUAs at E35/t Over 2008-20

Mark C Lewis is Director, Commodities Research - Global Carbon Markets, at Deutsche Bank AG

Summary of main points in article

The EU has a very ambitious energy-policy package out to 2020 which we think points to significantly higher carbon prices over 2008-20. The package comprises three main pillars:

- First, achieving a 20% reduction in the EU's greenhouse-gas (GHG) emissions against 1990 levels by 2020;
- Second achieving a 20% improvement in the EU's energy efficiency by 2020;
- Third, consuming 20% of all primary energy by 2020 from renewable sources, and building 12 large-scale carbon-capture and storage (CCS) plants in the EU by 2015.

These policy targets imply a very tough ETS cap for Phase 3 of the scheme, and we estimate a cut of 17% against the Phase 2 allocation.

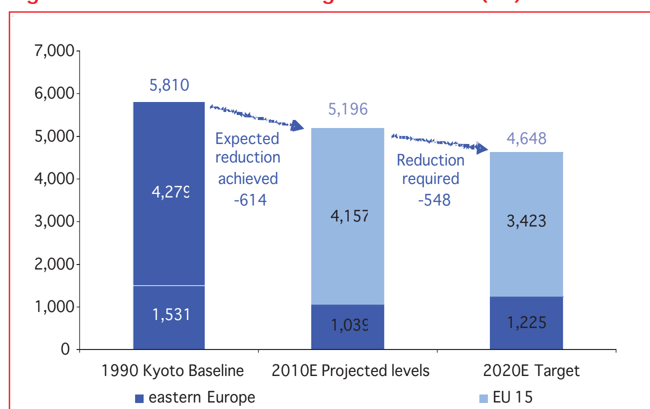
Arbitrage implied by the mandatory banking between Phases 2&3 should ensure a common price over 2008-20

As a result, we are now forecasting an EUA price of E35/t over both Phase 2 and Phase 3 of the ETS;

The EU target: a 20% reduction in GHG emissions by 2020

The EU is now committed to achieving a reduction in its GHG emissions of 20% relative to 1990 levels (Figure 1). Although this is not a commitment to an absolute cut – the target allows for the continuing use of credits from CDM/JI projects as offsets against excess emissions – it is nonetheless an extremely ambitious target, and this is for three main reasons.

Figure 1: EU GHG emissions targets 1990-2020 (Mt)



Source: European Environment Agency, DB Global Markets Research

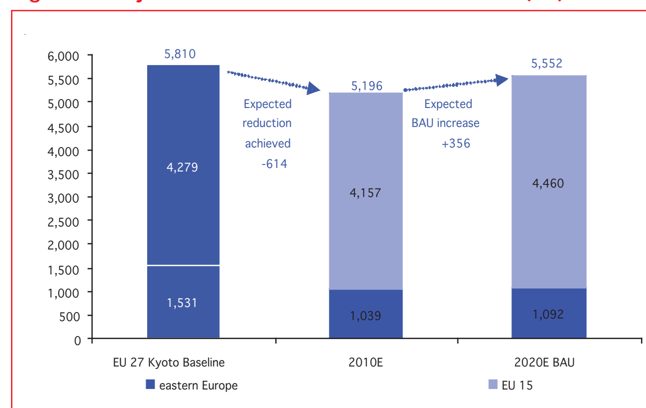
First, taking 2010 as the mid-point of the Kyoto compliance period and hence the baseline for calculating the "effort required" to the new target of 20% below 1990 levels, then on current projections the EU will have to achieve a reduction in emissions over 2010-20 of almost the same absolute magnitude as that expected over 1990-2010.

Second, the reduction over 2010-20 will have to occur without the one-off factors that largely explain the actual reduction in emissions projected to be achieved by the EU over 1990-2010 (the main factor here being the collapse of the Soviet system in eastern European countries).

Third, we then need to factor in the BAU emissions growth that would occur as the EU economy grows over 2010-20.

We assume annual emissions growth of 0.7% over 2010-20, which means that by 2020 annual emissions would be 904Mt above the EU's target on a BAU basis (Figure 2).

Figure 2: Projected EU emissions to 2010 and 2020 (Mt)



Source: European Environment Agency, DB Global Markets Research

Adding the implied effort required in each year over 2011-20 together and then dividing by ten gives us an average "effort required" over 2010-20 of 746Mt.

However, notwithstanding the very ambitious scale of the EU's 20% emissions-reduction target by 2020, the Commission has developed a much more coherent energy policy than it had in the past to help meet this objective.

This policy comprises three main elements: (i) a target to improve energy efficiency in the EU by 20% by 2020; (ii) a target stipulating that 20% of the EU's primary-energy consumption by 2020 should come from renewable sources; and (iii) a target to develop 12 large-scale CCS plants by 2015.

We assume that the demand-side target of reducing primary-energy consumption by 20% by 2020 will reduce the average annual "effort required" over 2010-20 by 197Mt. As a result, we assume that the EU's other policy measures will have to reduce emissions by an average of 549Mt per year over 2011-20 if the target of a 20% reduction in GHG emissions by 2020 is to be achieved.

We expect a much tougher ETS cap from 2013 …

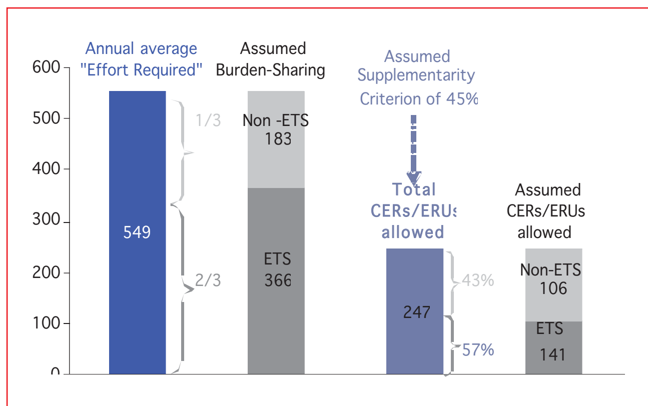
We assume that although the ETS currently accounts for only about 45% of total EU emissions, and that even with the full addition of the aviation sector from 2012 it will still only account for about 50% of total emissions, a disproportionately large burden of the "effort required" will be placed on the ETS in general, and the power-generation sector in particular.

As a result, we assume that 67% of the burden will be assumed by the ETS, and 33% by the non-ETS sectors of the EU economy.

On our estimates, this would imply a reduction of 366Mt per year in the Phase 3 cap relative to Phase 2 (Figure 3).

At the same time, we think that the Commission will interpret the supplementary criterion governing the use of CDM/JI credits in the ETS more strictly beyond 2010 in order to reflect the increased reliance on its supply-side targets for renewable energy and CCS projects laid down in its energy policy out to 2020. We therefore assume the Commission will allow only 45% of each Member State's "effort required" to be met via the use of CDM/JI credits over 2013-20 (compared with 50% over 2008-12). ▶▶

Figure 3: ETS assumed sectoral burden sharing, 2013-20 (Mt)



Source: DB Global Markets Research

… and this is bullish for EUA prices in both Phase 2 and Phase 3

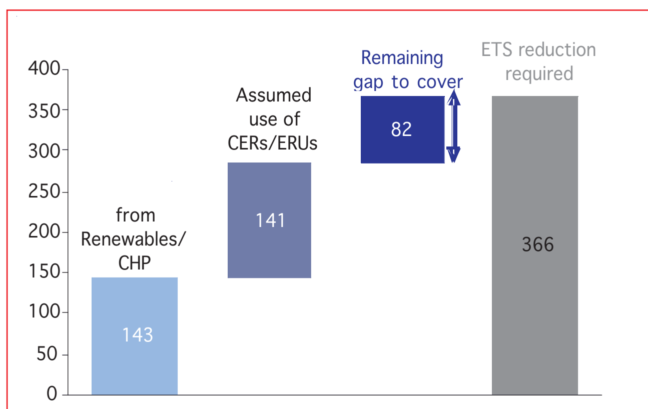
In order to work out the carbon price implied by our assumed "effort required", we need to calculate the residual amount of abatement that has to happen domestically within the ETS. To do this, we need to answer two questions:

1. What will be the impact of the target for sourcing 20% of all primary-energy consumption from renewables by 2020? If we assume that this full saving is achieved in linear fashion over this period then the average annual emissions savings over 2011-20 would be 143Mt

   In turn, this would mean that of the 366Mt average annual "effort required" for the ETS sector, 143Mt would be achieved through the Commission's renewable-energy targets, leaving a gap of 223Mt to cover.
2. How many CERs/ERUs will be available to the ETS sector? We assume that Member States will use 106Mt of CERs/ERUs per year over 2008-12. Assuming a total annual CER/ERU limit of 247Mt (Figure 3), the remaining amount available for the ETS sector would be 141Mt per year (Figure 4).

As a result, assuming that the full renewable-energy target were met by 2020, the ETS sector would have a remaining gap to cover via domestic abatement measures within the ETS of 82Mt per year over 2008-12 (Figure 4).

Figure 4: ETS, assumed average residual abatement required, 2013-20 (Mt)



Source: DB Global Markets Research

Indeed, the 82Mt number is conservative to the extent that we have above assumed that the target for achieving 20% of primary-energy consumption from renewable sources by 2020 is achieved in full. Evidently, if the target is not achieved in full, the residual abatement required by the ETS sector will be correspondingly higher. A range of 80-100Mt per year for the residual abatement required within the ETS therefore seems a reasonable assumption to make.

We think this points to an EUA price of Euro 35/tonne over 2013-20.

This is because we think 80-100Mt is a very material amount of emissions to be abated each year, and that it will largely have to be achieved via fuel switching in the power-generation sector.

We estimate that the opportunities for large-scale fuel switching are limited in the EU at the moment to three main markets, namely Germany, UK and Spain.

We have set out these estimates in much more detail in a previous research report (*What If? The risk of much higher carbon and power prices*, 1 November 2005, DB Global Markets Research), the point being that switching opportunities at the moment would allow for nearly 100Mt per year of emissions abatement per year.

Over time, however, as more gas plants are built across Europe, this number will increase, so we would argue that it is reasonable to assume that the full residual abatement required by the ETS sector over 2013-20 will be achievable via fuel switching.

So what are the economics of fuel switching, and hence the implications for carbon prices in the ETS over Phase 3? To answer this question we make the following assumptions on the key variables:

1. An average oil price over 2013-20 of $60/boe (DB's Commodities Research team long-term forecast)
2. A gas price of Euro 0.64/therm. At $60/boe this represents the average of the thermal equivalent gas price (Euro 0.72/therm) and the Troll index price (Euro 0.56/therm).
3. An all-in coal price of $80/t
4. A carbon price of Euro 35/t
5. Thermal efficiency of 57% for UK gas plant, 37-43% for coal, and 37% for lignite
6. A Euro/$ exchange rate of 1.38, and a £/Euro exchange rate of 1.48

On these assumptions, we think gas would start to look economic against coal in the UK, and fuel switching would therefore start to happen at this level.

In short, our assumption that the ETS will have to achieve residual abatement of 80-100Mt per year over 2010-20 implies a price for EUA allowances over 2013-20 of Euro 35/t.

Moreover, this has very significant implications for our price forecast for Phase 2 EUA allowances as well. This is because any EUAs that are not used in Phase 2 are carried over as a matter of course into Phase 3. In other words, there is mandatory 100% banking of surplus permits between Phase 2 and Phase 3, as is clear from Article 13 of the Directive that governs the ETS (Directive 2003/87/EC, 13 October 2003, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?).

What this means is that we effectively need to consider the entire 13 years covered by Phases 2 and 3 as one period, and thus to average our projected annual deficit over 2008-20. This results in a total expected residual abatement requirement in the ETS of 950Mt over the 13-year period, and an average residual abatement requirement of 73Mt per year.

We think a residual abatement requirement over this period of 73Mt will require significant fuel switching from coal to gas to be achieved, and in keeping with our analysis above we derive a price forecast for EUAs of Euro 35/tonne over 2008-12.

This article is written by Mark Lewis, Paris-based director of Commodities Research, global carbon markets at Deutsche Bank AG ("DB"). The opinions or recommendations expressed in this article are those of the author and are not representative of Deutsche Bank AG as a whole. DB does not accept liability for any direct, consequential or other loss arising from reliance on this article. Extracts from this article derive from previously published Deutsche Bank research. ■

Putting Market Forces to Work on Climate Change: Carbon Trading On the Rise

William Bumpers and Marcus Selig

As governments and multi-national corporations focus increasing attention on measures aimed at reducing greenhouse gas emissions, a growing reliance on market forces and emissions trading is emerging as a critical cornerstone of this effort.[1]

The growth in greenhouse gas emissions trading has been phenomenal, growing from a few million dollars in 2000 to more than $30 billion in 2006. The World Bank has projected this trade globally to reach as high as $100 billion per year by 2012, the end of the first budget period under the Kyoto Protocol. Since carbon dioxide (CO_2) is the dominant greenhouse gas, the emissions trading is often referred to as the "global carbon market."

That, however, is a misnomer. It is not a single market but, rather, multiple international, national, and regional trading regimes with different driving forces. The most important distinction between the various markets is whether they are based on mandatory or voluntary emission trading methods. Under mandatory programs, such as the Kyoto Protocol, participating governments implement cap-and-trade programs, imposing emission caps on companies and their industrial activities. Under voluntary programs, companies voluntarily undertake measures to reduce their emissions. Either way, the basic trading unit is one metric ton of CO_2 equivalent, or a carbon credit. How carbon credits are created, traded, regulated and tracked, however, varies greatly.

The basic trading unit is based upon CO_2 because it has the greatest atmospheric concentration of all greenhouse gases; however, other greenhouse gases do exist. For example, methane, one of the six greenhouse gases regulated under the Kyoto Protocol, has a warming potential that is approximately 22 times greater than CO_2. Thus, reducing one metric ton of methane emissions is the equivalent of reducing 22 metric tons of CO_2 emissions. The most potent greenhouse gas, sulphur hexafluoride, has a warming potential that is 36,000 times greater than CO_2, although it is usually found in extremely small concentrations.

Under a typical cap-and-trade program, the system administrator, such as a state agency or the US Environmental Protection Agency, will set an emissions limit and will give or sell an allocated amount of carbon credits to regulated entities such as a power plant. As the plant produces emissions, it will return or retire one carbon credit for every ton of CO_2 equivalent emitted. If the plant produces fewer emissions than allocated under the cap, it can sell its surplus credits on the open market. (The EPA administers markets in sulphur dioxide and nitrogen oxide emissions credits, and the New York Mercantile Exchange, Inc. lists futures contracts based on the program.)

Conversely, an entity can buy credits needed to make up a shortfall.

US carbon markets

Although the United States has elected not to participate in the Kyoto Protocol, there is nonetheless a nascent US carbon market that promises to be boosted by new regional and state-wide regulatory programs. Instead of waiting for federal action, a number of states have taken strides towards reducing CO_2 emissions through market-based programs. The first state-driven enterprise was undertaken by the Regional Greenhouse Gas Initiative (RGGI), a cooperative effort by ten Northeast and Mid-Atlantic states (Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, and Vermont) to curb greenhouse gas emissions from power plants.

The RGGI states have developed a mandatory cap-and-trade program that will regulate CO_2 emissions from fossil fuel-fired electric generators within the region. The first compliance period beings on January 1, 2009, with an initial emissions cap set at a level equal to 1990 emissions. Under the cap-and-trade program, states have the option of allocating or auctioning allowances. Most states, however, have indicated that they plan to auction the majority, or all, of the allowances to the sources in their states.

On the West Coast, California is planning an aggressive effort to develop a comprehensive, economy-wide climate change strategy aimed at achieving a 25% reduction in CO_2 emissions by 2020. The largest component of California's climate change initiative is the development of a mandatory cap-and-trade program. California eventually hopes to require compliance from all CO_2 emitting sectors (energy generation, manufacturing, transportation, agriculture etc.) under the cap-and-trade program. By 2012, California plans to allocate carbon credits through a combination of free allowance allocations and auctions, with a decreasing amount of allowance allocations in subsequent years.

Additionally, the California program will allow for the importation of carbon credits earned through offset programs established both within and outside the State. California's efforts are likely to lead to further expansion of cap-and-trade programs through linkages with other mandatory cap-and-trade systems. Five other states and two Canadian provinces already have joined California to form the North American Western Climate Initiative, a regional initiative similar to RGGI. The group hopes to reduce their collective CO_2 emission by 15% by 2020 using a cap-and-trade program.

Voluntary carbon markets

While the mandatory cap-and-trade programs are the backbone of government-driven policy objectives, there is a robust voluntary emissions market that, in some ways, is outpacing the mandatory efforts. In the United States, an increasing number of major corporations are taking highly public positions in favour of federal climate change legislation. In the interim, however, companies are taking advantage of opportunities to engage in emissions trading through the voluntary emission markets.

There is no shortage of companies who offer to sell greenhouse gas offsets to individuals and companies that wish to reduce or neutralize their so-called carbon footprint. For example, TerraPass, one of the early offset providers, offers to offset carbon emissions generated by driving, flying, heating and cooling one's home, or running a business. TerraPass purchases the offsets from qualified developers of projects designed to reduce greenhouse gas emissions, principally from landfill methane capture, agricultural methane reductions, and wind energy developments.

On a larger scale, major corporations are getting into the carbon business. General Electric Co. recently announced a joint venture with AES Corp. through which they plan to invest $100 million in greenhouse gas reduction projects to produce marketable offsets. Wal-Mart has invested millions of dollars to determine its carbon footprint and to invest in technologies and measures that will make its operations more carbon efficient. Similarly, CitiGroup has announced that it will direct $50 billion over the next 10 years toward investments and projects that address climate change.

The voluntary carbon market, however, is not without its problems. Perhaps the largest problem is the market's lack of standardization. Although everyone trades in the basic one-metric-ton unit, there is a lack of consensus regarding which projects and project types should be recognized as legitimate greenhouse gas reduction projects.

There also is little consensus regarding how to validate and verify projects and their resulting greenhouse gas reductions. In the absence of binding and transparent regulations that govern the standards and ownership of such emission reductions, some environmental groups have questioned the legitimacy of voluntary emission reductions. The International Emissions Trading Association has convened a multi-national and multi-industry stakeholder process to address this issue, with the objective of developing a Voluntary Carbon Standard this year that will govern the voluntary trading market.

Financial institutions are getting involved as well, with Morgan Stanley spearheading an initiative with other financial heavyweights, including ABN Amro, Citigroup, Barclays Capital, Deutsche Bank and ▸▸

Credit Suisse, to establish a voluntary offset standard that gives consistency to the voluntary market.

The prospects for Federal legislation

Although the existing US carbon markets provide numerous investment opportunities, the future of the carbon market in the United States will be shaped by future federal climate change legislation. With ten separate bills containing cap-and-trade programs introduced during the 110th Congress and an increasing call from major US corporations to act on climate change, the creation of a national system appears certain. Although each of the bills varies in terms of the emissions reduction target, allocation scheme, scope of industrial inclusion, and timeframe, the one constant element of all of the bills is the use a market-based cap-and-trade program to achieve the legislative goals.

The United States emits more than 6 billion metric tons of CO_2 equivalent each year. If legislation is adopted that generally reflects the scope of the mandated European Union Emissions Trading Scheme, companies accounting for as much as 3 billion metric tons of emissions per year will be subject to emission caps. As a result, any federal bill is certain to create a market that dwarfs the existing US voluntary and mandatory regional markets that will go into effect in the coming years. With projected prices that range from $10 to more than $50 per metric ton, the potential value of the US carbon market is huge.

Mandatory programs: Kyoto, EU

The Kyoto Protocol is the largest and best known compliance-based cap-and-trade system. Kyoto was ratified by participating countries and went into force in February 2005. Under Kyoto, participating developed countries agreed to reduce their greenhouse gas emissions to approximately 5% below their 1990 levels by 2012. To achieve this goal, Kyoto utilizes what are referred to as "flexibility mechanisms," essentially market-based tools that help ensure that emission reductions are carried out using the most cost-effective and economically efficient means possible.

The three flexibility mechanisms envisioned by Kyoto are emissions trading among companies located in participating developed countries; the Clean Development Mechanism, which allows developing countries to create tradable credits to sell to companies in developed countries; and Joint Implementation, which allows direct investment in greenhouse gas-reducing projects between participating developed countries.

European Union Emission Trading Scheme

Leading up to the first Kyoto Budget Period (2008 to 2012), the European Union initiated a three-year trading program, essentially a trial run, to help ensure that the regulatory and financial infrastructure would be in place for the start of Kyoto. The first phase of the European Union Emission Trading Scheme ran from 2005 to 2007, and gave key affected industries and financial institutions a three-year training period prior to the start of the first Kyoto Budget Period.

The training run was a mixed success. On one hand, in 2006, the EU trading program saw $24.4 billion in carbon trading. On the other hand, there was an exceedingly high degree of price volatility due to a number of factors, including an over-allocation of allowances, poorly timed information releases, and the fact that the allowances cannot be banked, or carried forward for compliance beyond 2007. Thus, the price of allowances ranged from a high of approximately €30 in 2006 to the current price of only €0.10.

The EU trading scheme showed where improvements were needed, but also clearly demonstrated that companies could adjust to the trading of emission allowances quickly and efficiently. In its first year, 322 million EU allowances were traded, valued at $8.2 billion. In 2006, a three-fold increase in the volume of traded EU allowances (1.1 billion metric tons of CO_2) and an April 2006 peak price of €30 per metric ton of CO_2 allowed for a three-fold increase in the market's total value. These market gains were seen despite heavy market fluctuations and a collapse of allowance prices as Phase I neared its end. Due to the promise of an expanded Phase II compliance and allocation period and the simultaneous start of the first Kyoto budget period, forward contracts for Kyoto-compliant 2008 EU allowances are trading at around €19 (approximately $26) as of August 2007. The market is proving highly resilient.

The first Kyoto Budget Period, and Phase II of the EU program, is likely to be greatly expanded in its scope and strength. On the supply side, investments previously made in Clean Development Mechanism projects in the developing world will begin producing an increased stream of certified emission reductions. Similarly, Joint Implementation investments should increase significantly as Russia and other Eastern European countries finalize their rules for such projects.

Offsetting this increase in supply of compliance credits from these projects, the emission levels in Europe will be significantly tightened, with the average reduction about 8% lower than during Phase I. Additionally, the rest of the participating developed countries, principally the former Soviet Union and Japan, will begin participating in aspects of the market. Japan, in particular, is expected to be a significant buyer of certified emission reductions.

Finally, European regulators plan to include aviation emissions (10 million to 12 million metric tons of CO_2 per year) when calculating each participant states' annual carbon emissions, further strengthening demand in compliance credits. Cumulatively, these changes should result in a shortfall of 200 million to 300 million European Union allowances per year, and some analysts project a firming of prices during the first Kyoto Budget Period. Emmanuel Fages, an analyst with the French investment bank Société Générale, expects European Union allowances prices to range between €20 and €40.

Conclusions

There is significant uncertainty surrounding the global carbon market. As of late August, the parties to the Kyoto Protocol have not agreed on what will happen after the first Kyoto budget period ends in 2012. It is also risky to predict whether or when the United States may pass national legislation to address climate change. Additionally, China, India, Brazil, Korea, Indonesia and some of the other high-emitting developing countries are struggling with whether they will accept limitations on their emissions in the future. The evolution of these issues will have profound impacts on the carbon markets globally and regionally.

Among this uncertainty, however, the mandatory and voluntary markets are blossoming in the United States and Europe, and unprecedented financial might is poised to flow toward new technologies that reduce greenhouse gas emissions. All of this ensures that there will be a vibrant global carbon market for some time to come.

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1. *This article was originally run in the Fall edition of the NYMEX publication @the Market and is reprinted with permission from the authors.*

Market-Based Carbon Emission Reductions Are Best: Lessons the Nascent Cap-and-Trade Programme in the North-eastern US Can Learn from the EU Experience

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Introduction

There has been an ongoing debate in the United States about whether carbon reductions are more effectively achieved through taxation or through a cap-and-trade program. We believe the answer is clear: a well-structured cap-and-trade program is superior to a taxation program because it would elicit financing and risk management products that will lead to capital investment, and it will do so in a more economically efficient manner than carbon taxes. The value of a cap-and-trade mechanism is that producers across different sectors with different marginal carbon abatement costs can trade among themselves to minimize the societal cost of reaching the emissions targets. This has been well documented in economic literature. A tax would not produce this economically efficient result.

One of the main arguments raised by cap-and-trade opponents is that price under such a programme might change with different market conditions and may be volatile. This volatility and lack of known prices will tend to deter investment in carbon reducing technologies, so say the critics. If this argument is to be believed, than we must re-examine virtually every commodity market in existence, as most of them can be described as having unknown and potentially volatile prices. Yet, capital investment seems to occur in those markets. To put it simply, farmers don't know what the price of wheat is going to be when they harvest in the fall, but they plant seeds and invest in capital improvements anyway. How do they do this in the face of uncertain prices? They use futures markets and financial intermediaries to hedge their bets. A properly structured cap-and-trade programme would bring the same opportunities.

Some of the components of a successful carbon cap-and-trade programme are: multi-sector coverage to make the market as deep and liquid as possible, a long programme life enabling investors to realize the benefits of long-term capital investments in carbon reducing technologies, and allowing unused allowances in the current timeframe to be banked for future years. These components are important because, as a result, forward physical and financial markets for CO_2 allowances will develop and financial intermediaries will subsequently be able to enter the market to hedge the inputs and outputs necessary to finance some of the technologies. In fact, one of the clear successes of the EU's emissions trading system (ETS) is the development of an international offset market through the Kyoto Protocol's flexible mechanisms. According to Point Carbon's CDM & JI Monitor, there are currently 2,526 projects, potentially yielding 2,618 million tons of CO_2 reductions by 2012, that are in the design stage. The investments needed to achieve these emissions reductions are made, in large part, based on the forward price in the EU's Emissions Trading Scheme.

The North-eastern United States Regional Greenhouse Gas Initiative (RGGI)

In January 2009, ten states in the north-eastern US are to commence the country's first carbon cap-and-trade programme. RGGI caps the carbon dioxide (CO_2) emissions of electricity generators larger than 25MW, with the ultimate target of reducing their emissions by 10% below current levels by 2019.

One of the widely publicised drivers for the development of the RGGI programme was for these ten states to provide leadership in the development of a cap-and-trade programme that would pave the way for a federally mandated US economy-wide system. On this front, RGGI has somewhat succeeded already, as there are several high profile pieces of legislation in the current Congress proposing cap-and-trade schemes.

Another key driver for the development of RGGI is to actually reduce emissions by putting a price on CO_2. Adoption of such a market-based mechanism is laudable, and in order to accomplish their goal, RGGI policy-makers can learn some valuable lessons from the experienced participants – including active traders such as Barclays Capital – in Phase I of the EU's Emissions Trading Scheme (ETS).

Before addressing a few specific concerns, an overarching issue with RGGI is its relatively small size, covering just 180 million tonnes of annual CO_2 emissions, compared to Europe's more than 2 billion tonnes. The result may be a lack of depth and liquidity in markets for RGGI allowances, which may prevent financial institutions from being able to provide the financing and risk management tools to the utilities captured by the scheme, and to investors funding new CO_2 reducing projects and technologies. Whether the market develops remains to be seen, but RGGI policy-makers should take every opportunity to expand the programme as much as possible, including other sectors, and by linkages with California's planned ETS and the global carbon markets.

That being said, there are some well-publicised issues with Phase I of the EU ETS that are being addressed in the RGGI design. For example, the programme covers a 10-year timespan, and unused allowances in early years can be banked for future use. Further, most allowances are to be auctioned in the market instead of allocated directly to generators, boosting liquidity and avoiding windfall profits (where generators have been able to add the cost of carbon allowances to the power price, despite often receiving allowances from government at zero cost). Also, state-of-the-art emissions data verification is already in place throughout the RGGI region, which was simply not the case in Europe.

However, two potentially market crippling issues remain unaddressed.

The first issue is the potential oversupply of allowances. Clearly, a programme with more allowance supply than demand from generator emissions will not achieve RGGI's goal of reducing CO_2 emissions and will result in low, or even zero, prices. One of the problems is that the RGGI targets were set several years ago, roughly using emissions levels during 2000–02 as a baseline. Two recently released studies indicate that RGGI will be oversupplied throughout much of its 10-year term as a result of recent generator fuel switching from oil to natural gas. If this is true, RGGI decision-makers must reduce the amount of allowances to be auctioned or allocated in the program.

The answer is not to set a price floor and then hold onto unsold allowances for future auctions, as has been suggested by some. The price floor alone does not solve the oversupply problem because, as long as participants know that allowances are still out there, and may flood the market at any time, there is likely to be very little market activity besides compliance purchases by generators at the floor price. True, by setting a floor price, states may generate some revenue for themselves from the auction, but they will not achieve the goal of actual emissions reductions.

Instead, the states in the RGGI region should update their baseline emission amounts to account for the recent fuel switching phenomena, and then issue a reduced amount of allowances accordingly. Only by making fewer allowances available than expected emissions will the RGGI programme lead to reduced emissions and a price derived from a market.

The second key lesson RGGI policy-makers can learn from the EU ETS is to publish the latest aggregated emissions data from affected generators well before the first auction, expected to be in mid-2008. These numbers have not been publicly updated in several years. Without knowing what generator emissions will be in the years immediately preceding the start of RGGI, and what initial demand for ▸▸

RGGI allowances will be, participants won't know how to value the allowances correctly. Surprise data could lead to a price shock once the actual data is released. RGGI policy-makers should avoid this situation by publishing updated emissions information.

Both of these issues have been shown to be a problem by early trading in the EU ETS. The market opened prior to the release of updated emissions data from many participating countries. At that point, most of the market thought that Phase I was short (ie that there were fewer allowances than expected CO_2 emissions), as reflected in healthy prices in the €20-€30/tonne of CO_2 range. However, in early 2006, when actual emissions figures for 2005 were published, it showed that the market was actually very long, leading to an immediate and dramatic price correction, followed by the slow collapse of Phase I prices to their current levels of €0.08/tonne. This correction constituted a perceived failure in the programme and is one that can and must be avoided by RGGI given the existence of reliable emissions data and the experience of Europe.

Conclusion

The RGGI states should be applauded for taking the lead in implementing a groundbreaking CO_2 cap-and-trade programme in the US. Only through the implementation of a market-based programme will the US achieve its emissions reductions in the most cost-effective and efficient manner. There are many positive elements to RGGI's design, such as the auctioning of most allowances. However, the changes suggested above will help to ensure the scheme meet its goal of reducing emissions, and creates a viable carbon market. ■

Eradicating Energy Insecurity

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If national governments maintain their current policy stance, the unexpectedly rapid ascent of the economies of China and India will lead to a 50% rise in energy needed to power the global economy in 2030, according to the International Energy Agency. A ramp up in energy demand will ratchet up concerns for global energy security and climate change, the agency warned recently in its annual World Energy Outlook.

The heavy capital requirements and long time frame needed to make the massive investments in energy infrastructure required to meet rising this future energy demand – $22 trillion through 2030, according to the IEA's recent estimate - will oblige governments to put in place the right policy framework to spur business investment in cleaner and more efficient technologies. Long-term policies are also needed so business can disseminate the latest technologies to countries in the developing world – where half of future energy demand will come from.

Business plays a central role in energy security. In addition to providing significant investment, business produces, transports, and distributes energy. Access to reliable and affordable energy is a lifeline for business, so business can continue generating economic growth, developing infrastructure, creating jobs, transferring technology and meeting global commitments to construct a cleaner world for future generations.

To enhance global energy security, what is needed first and foremost for business to make these investments are commitments by governments to open markets, diversify energy supplies. Governments must also recognize the growing interdependence of global energy markets and underlying political interdependence - and their in this process.

Short-term thinking should be avoided. Short-sightedness undermines energy security. Energy policy must also look beyond the sector to the wide range of possible ripple effects on the economy and on regional and international relations. A country which is a net energy exporter must consider how its national energy policy will affect net importing countries, for example.

The tax, legal, and regulatory regimes of countries must be in place to promote investment and to encourage technology transfer. Governments need to give assurances contracts will be honoured, intellectual property will be protected, rule of law will be maintained and enforcement will be even-handed.

Ongoing dialogue with the private sector will be necessary so government policies accomplish what they set out to do. Governments must also remain steadfast in eliminating bribery and corruption in tandem with business, something in which ICC is involved: promoting and spreading best practices.

Leaps in technology will also have a big impact on the configuration of a secure energy supply in the future. Promising technologies such as carbon capture and storage, advanced nuclear technologies, hydrogen, biomass and solar need to be nurtured. Public assistance for pre-commercial research is a must.

And while open markets are the best assurance technology investments will be made, governments should offer Official Development Assistance to boost development of low-carbon technologies.

For the least-developed countries, funding from intergovernmental organizations such as the World Bank can help fill the gap where access to capital is limited. For developed countries, where the challenge lies in renewal of existing energy infrastructure, market-oriented policies may be needed in parallel with policies and regulations to increase the reliability of electricity networks.

Maintaining a diverse mix of energy sources is key to promoting energy security. No energy or technology sources should be excluded from consideration to meet growing future demand. Here again, public policies are needed to lay out guidelines for safe and environmentally responsible use and production of energy.

Greater investment in research will be needed to identify the most promising new technologies that help promote energy efficient production processes or expand the sources of energy supply. Government and industry must pursue long-term research programs geared at discovering more sustainable energy systems down the road.

Governments must create incentives for ambitious research programs. But they must also promote the training and development of engineers and scientists who will help spearhead the move to a low-carbon world.

Another pillar of promoting energy security is the reliability of energy transport and infrastructure, from LNG terminals to high-voltage electricity grids to gas pipelines. Interconnected energy systems, whether for oil or electricity, help reduce risk and create a more supple system at regional and global levels.

To make sure the electricity flows even in the event of a disruption, agreements must be fulfilled under all circumstances and governments must cooperate with transmission system operators.

When energy installations are in the path of natural disasters or other catastrophes, coordinated contingency management and disaster planning is vital to protect the supplies of energy.

To ensure that the energy system recovers as quickly as possible may require not only extensive and ongoing discussion with the private sector but also planning and cooperation at an international level to leverage all efforts.

Energy users, from companies to consumers, also share in the challenge to enhance the security of the world's energy supplies, through judicious energy use. The wisest policy to encourage economical energy use is harnessing market forces. This will lead to energy prices that reflect true costs, serving as a powerful incentive for users to curb energy consumption, which can have a significant impact on the supply of energy. ▸▸

Prince Albert II of Monaco recently called ICC "an essential link between local and international players."

ICC's Commission on Energy and Environment served as this link when it discussed these requirements during the UN Framework Convention for Climate Change in Bali, one of the forums where discussions are taking place on global frameworks to curb greenhouse gas emissions.

In Bali, ICC delivered statements on sector development, technology and climate change to the negotiators. ICC also delivered a clarion call for more dialogue between business and government.

In 2008, ICC will also deliver a statement on climate change to the leaders of the G8, in the run-up to their annual summit in Hokkaido next July. Business involvement is key to pick up the pace of these discussions with governments, to find ways to increase energy security for the planet. ■

Sustainability and the Risk Management Function: How to Integrate Risk Management into Sustainability Programs

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Introduction

Sustainability recognizes that economic performance must be coupled with concern for social, environmental and ethical factors if business is going to continue to provide value to stakeholders in future generations. While corporate officers and directors are beginning to understand these concepts, the underlying principles that drive sustainability can be elusive and measurement of performance can be deceptive. Evaluation systems that have scored sustainability performance have measured tangible factors. This is both logical and practical since most corporations that performed well in terms of traditional economic measures also lead their industries in what are perceived to be the major elements of sustainability.

It is possible, however, that this model is not providing accurate results in measuring intangible factors that can also affect the results of corporate performance over the long term. Much like the iceberg that is mostly hidden beneath the surface of the water, sustainability may be more dependent upon factors that are not easily measured and the most damaging areas of corporate activity (in terms of long-term sustainability) may be among those that are not currently evaluated in assessing sustainable performance or considered in managing corporate risks.

Objective measurements that result in conclusions that an entity is or is not sustainable revolve around traditional evaluations of performance, including factors such as corporate governance, environmental compliance, affirmative employment initiatives and balance sheet strength. By adding inquiries concerning risk management, philanthropy and business ethics, a snapshot of sustainable performance is developed. A template is then applied to this objective data for scoring sustainability and segregating high performers from those that are not performing as well.

Shareholder value is, however, impacted by a number of other factors that may have more to do with long-term value than those measured by traditional scoring systems – the submerged portion of the iceberg if you will – that can cause business failure where success would otherwise be predicted. In his textbook on corporate value, Bob Willard describes this phenomenon and estimates that as much as 80% of value is now dependent on intangible factors. These areas are not typically addressed by traditional risk management programs that focus on tangible factors, even though the submerged portion of the iceberg is what tears through the hull of the unsuspecting ship.

Intangible factors that affect shareholder value

While an exhaustive analysis of the intangible factors that affect the value of a corporation's stock is not possible in this brief article, some of the areas that should be considered in evaluating the effectiveness of a corporate sustainability program include:

- Climate change and global warming
- Brand name value and reputation
- Productivity of employees (separate from attraction and retention)
- Efficiencies in manufacturing processes (including lower costs)
- Efficient use of energy (not just reductions in demand)
- Conservation of consumable resources, especially water
- Innovation and investment in research and development
- Environmental management (contrasted with environmental compliance)
- Reduced costs of physical facilities (including use of work at home programs)
- Customer satisfaction – know who you sell to and why they buy your goods and services
- Supply side security and diversity
- Risk mastery (beyond risk management) - to buy less insurance and provide better protection for catastrophic risks
- Thought leadership and enlightened management
- Involvement of employees and customers in sustainability activities

Utilizing intangible factors clearly results in a more complex analysis than has been undertaken in the past since it incorporates two additional dimensions – time and second-order effects. The short-term mindset of nearly all financial analysis has been carried over into the measurement of sustainability, while in reality most successful business strategies look at where the world will be in 36 months or 10 years, and not at the results of the current quarter.

Second-order effects are those that are inevitable once a change occurs, but will be missed if management is single-focused on bottom-line results or the selling price of stock. For example, with climate change, warmer temperatures will affect owners of ski resorts by shortening seasons or requiring the operation of snow-making equipment, but for other businesses, warmer weather may also result in more severe tropical storms, more frequent flooding, coastal storm surges and forest fires. Beyond these more obvious impacts are severe water shortages, displacement of populations and higher costs of all forms of energy. All of these primary and second-order impacts can have material risk management implications.

To continue with our climate change example, an analysis of a corporation's long-term strategy on climate change is far more relevant to its future viability than a snapshot of its current carbon footprint. The combination of increasing global energy demand, reaching the maximum possible production levels for fossil fuels and the lack of viable alternatives to these fossil fuels is certain to result in higher costs of energy. At the same time regulations will impose stricter standards on emissions of greenhouse gases and solid particulates. Corporations that are investing in lower-carbon energy and more efficient ways to use energy will have a tremendous advantage over those that do not see the risks or the opportunities inherent in the climate change area.

Practical risk management activities involving sustainability issues

In visiting with corporate clients investigating sustainable business practices, Aon is often asked if it can demonstrate that companies with sustainability programs have been able to achieve increased shareholder value. While there are many anecdotal examples of

correlations between sustainability programs and increased stock value, the many factors that can influence the value of publicly traded stocks make such proof impossible. As a leading provider of risk management consulting services, we often suggest that clients consider intangible factors as well as shareholder value in evaluating the benefits of implementing sustainability programs – especially those factors that have a direct impact on the cost of risk.

Risk managers have a unique opportunity to be actively involved in the sustainability programs of their companies. Those who have grasped the significance of sustainability issues have found the risks and opportunities associated with intangible sustainability issues are much like the traditional (insurable) risk areas they have worked with in the past. Being a part of the solution to the emerging risks of sustainability can greatly enhance the roles of risk managers and broaden their participation in corporate planning and decision making. A discussion of selected sustainability risks will provide illustrations of how risk managers can be drivers of activities that will build shareholder value and improve sustainable performance.

1. Global Warming – Climate change impacts risk management programs in many ways that are often not apparent to risk managers. Furthermore, the magnitude of some climate change risks will not be immediately apparent because they manifest themselves over a period of years (ie second-order effects discussed above). Risk management programs tend to focus on short-term impacts and costs and may overlook issues that evolve over time. More severe and more frequent windstorms, floods and forest fires are creating availability and affordability problems for insureds in many areas that are subject to extreme conditions. Insurers that are not able to make adequate rate adjustments may withdraw from participation in insuring residential and commercial accounts in areas of high risks. When commercial insurers withdraw, government programs may be the last resort for both personal lines and commercial insureds.

For example, in Florida, Citizens Insurance Company, a government-operated property insurer is now the largest writer of property insurance in the state. Since the objective of this insurer is to preserve a market for state residents and commercial accounts, it is unlikely to charge adequate rates for the long-term costs of risks it insures. With its inadequate reserves, Citizens is one catastrophic loss away from bankruptcy. The State of Florida also writes reinsurance for commercial insurers that are still writing property risks in the state, but its rates are inadequate in this area as well. In fact, they are roughly one third of the rates charged by commercial insurers for the same risks. All of this is a formula for disaster for homeowners and businesses with operations that could be impacted by storm losses in the state of Florida.

With respect to hurricane damage, Factory Mutual reported that it saved more than $500 million during the storms of 2005 as a result of risk management measures its insureds took to make properties resistant to wind damage. The cost of these measures was less than $2.5 million, making the return on investment approximately 200 to 1. If similar risk management activities were broadly embraced in areas subject to severe windstorm damage, the savings could be tens of billions of dollars from the next major hurricane that makes the shore of the US. Similar measures can be taken for forest fires in the western states and floods in the Midwest. In terms of long-range planning, risk managers should press for decisions to locate facilities away from coastal areas whenever possible. Where buildings must be located in areas subject to severe storm potential, design and construction should be incorporated that provides protection against windstorm and water damage.

Global warming is also contributing to severe drought conditions in many parts of the world. If current trends continue, water shortages may result in slower economic growth in areas that are now experiencing the highest rates of industrialization. In China and India, where water resources are much more limited than in the United States, water shortages are already impacting manufacturing operations that require both large quantities of water for cooling and high quality water for food or beverage production. For corporations that are engaged in manufacturing in these countries, the availability and cost of water may be a problem as water resources are further strained in the future. US beverage manufacturers have already experienced interruptions in manufacturing operations in overseas locations as a result of the poor quality of available water resources in times of severe drought. Such problems are certain to be more frequent in the future as water shortages become more severe and water pollution worsens under the pressure of growing industrial and residential use.

In the United States, severe drought conditions in the Southeast and Southwest have demonstrated that business and personal use of water resources cannot be taken for granted in any part of the world when climate change is occurring. For paper mills and power plants that may require as much as 50 million gallons of water a day, water shortages have resulted in periods of curtailed output. US cities and states that rely on the Colorado River for water are all experiencing severe shortages that will certainly result in disruptions in personal and business affairs. While water has always been a relatively cheap resource, the current scarcity is also likely to result in much higher costs, especially where desalinization of sea water is the only substitute available for current fresh water sources.

Risk management measures for businesses that depend on water resources include selection of sites that are located near reliable sources, designs that make use of recycled water for landscaping and other non-potable activities and improvements in operations that reduce water consumption. Large roof areas and parking lots can be used to capture rain water and runoff that can be used for irrigation or to recharge local aquifers.

New sources of water will have to be developed to supplement current resources as world population grows from 6.7 billion to more than 9 billion by 2040. Conservation alone will not be enough to provide safe water to the large number of new residents of countries experiencing the highest rates of growth. Even now, almost one third of the world's population does not have access to safe drinking water or waste water treatment facilities.

2. Environmental Activities – Corporations are finding that hiring and retaining younger employees may require that they engage in a variety of activities to prevent damage to the environment. These activities may range from constructing or leasing environmentally friendly buildings, encouraging fuel conservation through car pools and the use of public transportation, recycling and conservation of non-renewable resources.

Many companies are moving toward requirements that new facilities meet the higher environmental standards such as those incorporated in the LEED Certification program of the Green Building Council. Standards applicable to new and existing buildings include the use of renewable resources and recycled materials, energy efficiency, more efficient water use and lower emissions of greenhouse gases. These features are being incorporated in office buildings, manufacturing facilities, retail structures and residences. When employers demonstrate their interest in these "green" facilities, employees are more likely to stay and they will also enjoy a more healthy and productive work environment.

More than productivity may be at stake in attracting and retaining employees. A client we visited recently discovered that one of its most serious risk issues was the loss of key employees. Further investigation by Aon's Human Resources Consultants indicated that the company was experiencing a turnover rate that was more than three times the average in its industry and the cost of replacing a key employee turned out to be more than $150,000.

Given the number of employees and the rate of turnover, this problem was costing millions of dollars every year and caused disruptions in operations that resulted in dissatisfaction on the part of customers. Of course, environmental factors were only a part of the answer to this turnover problem, but they were a relatively inexpensive part of the solution. Implementing changes in working conditions and beefing up the environmental program, along with compensation changes, career path planning and mentoring, enabled the client to reduce its turnover rate to below the industry average and to dramatically reduce its costs of hiring and training new employees. Reduced absenteeism and increased customer satisfaction were additional benefits associated with these changes in employment practices.

Environmental activities may not only result in lower costs of operations, but may greatly improve the public image of companies that are able to demonstrate the tangible aspects of their sustainability programs to stakeholders. Retailers like Wal-Mart and Kohls are building stores that have better insulation, skylights to reduce dependence on artificial lighting, high-efficiency HVAC systems, recycled building materials and other features that save money in construction and operating costs and are readily apparent to customers. Wal-Mart saved $28 million by recycling cardboard and paper wastes that it had previously sent to landfills. Kohls is experiencing 20% reductions in energy costs in its new environmentally friendly department stores. These facilities are changing the public image of retailers and providing employees better working conditions. Competitors that do not recognize the benefits of these sustainable practices may fall farther behind these industry leaders if they fail to implement similar improvements.

3. Energy Efficiency – The world is headed towards an energy crisis that will require the conservation of non-renewable resources, the development of alternatives to fossil fuels as primary energy sources and improvements in efficiency that are currently being overlooked. World oil production is expected to peak in the next decade. Population growth and rapid industrialization of previously agrarian nations are occurring at a time when no feasible alternatives to fossil fuels are available. This "perfect storm" in the energy sector will have profound impacts on industries that depend on the availability of relatively cheap power. Today, the only cheap source of power that can be developed rapidly enough to meet the growing demands of industrialized nations and emerging economies is coal, and even new coal-fired power plants will add significantly to emissions of greenhouse gases and solid particulate. The development of coal-fired power plants and dirty manufacturing facilities in China have already resulted in greenhouse gas emissions from that nation that surpass those emitted by US sources.

A significant portion of the problem is due to the inefficient use of power in all parts of the world. The model of large-scale power plants that concentrate generating activities to a limited number of sites needs to be examined. Small power plants can make better use of the heat generated as a by-product of power generation and allow the substitution solar, wind and other power sources for fossil fuels. To implement this solution, political decisions will have to be made that allow decentralized development of power sources and the current monopoly of power generators in many countries will have to be broken. Other available resources will have to be considered, including nuclear fuel if it can be used safely and without offsetting environmental damage. The storage or reprocessing of spent fuel rods will also have to be resolved by technical advances and political compromises on a national and/or global basis.

Risk managers should be studying power use trends and costs of their operations to evaluate possible impacts on present and future business activities. This investigation should be done with a view that higher energy costs are just around the corner. With this in mind, risk managers should determine what can be done to reduce energy use and to make operations less dependent on sources of power that could be impacted by events beyond your control. The fact that energy costs make up a relatively small part of the total costs of most businesses may hide the potential risks of higher future costs. Energy efficiency and lower greenhouse gas emissions should be priority risk management activities of every corporation, even though these activities may have a significant short-term impact on shareholder value.

4. Taking Sustainability Home – Many businesses are not engaged in activities that have material impacts on the environment or on the communities in which they conduct operations. After improving the efficiency of owned and leased facilities, implementing programs to minimize the use of non-renewable resources, instituting recycling programs and other sustainability measures, these companies should look at the next available opportunity to enlarge the impacts of their activities – sending sustainability home with employees and customers. For companies with thousands of employees and even larger customer bases, the impact of spreading the message of sustainability may have a far greater impact than measures taken within the organization (See "Ten things everyone can do to be sustainable" in inset).

If recycling within the corporation can save non-renewable resources, imagine what it can do in the homes of employees and customers that also implement recycling programs at their homes. The same is true for improvements in energy use, water conservation and emissions of greenhouse gases. Employers can offer incentives to encourage workers to engage in sustainable practices at home, but the most important contribution they can make is to lead by example and to provide employees with adequate information to allow intelligent decisions to be made on their own merits.

Of course, sustainability at the corporate level involves other principles that can also have a positive impact on the home and the community, including the adoption of practices that incorporate fair treatment of all people and concern for social values in communities where employees and customers live. Transparency is also a valuable attribute that can be taken home and employed to reduce the confusion over motivation that may be unclear where inadequate information is provided concerning business or personal activities.

Over time, the adoption of sustainability principles by corporations (and the export of these concepts and activities to the homes of employees and customers) can change the world for the better. Sustainability does not suggest a reduced standard of living in order to accomplish environmental objectives. In fact, it requires that today's standard be preserved or improved and made available for future generations. What may change in accomplishing sustainability goals are personal and social values, resulting in shifts away from inefficient uses of non-renewable resources toward practices that are more compatible with efforts to conserve and fully value resources that have been given away for centuries.

Conclusion

While changing the world may not be listed among the objectives of corporate sustainability programs, urgent efforts to take appropriate risk management measures to assure the viability of the corporation may start a process that does just that. Sustainability adds the consideration of time and second-order effects to the analysis of risks and assures better decision making that will enhance current performance and increase long-term stakeholder value. Many risks that are benign in the short-term may have serious consequences when viewed over a longer period of time. Aon is working with its clients to identify risk factors that can threaten the future survival and financial success of its clients and to develop risk management strategies that address a broad spectrum of exposures including emerging risks related to sustainability issues. While incorporation of these factors into risk management programs cannot assure an immediate impact on shareholder value, it will assure that factors critical to long-term corporate success will not be overlooked at the expense of current short-term results.

Ten things everyone can do to be sustainable

1. *Know your carbon footprint and work to reduce it over time – For a target, you should aim at reducing your carbon footprint (emissions of CO_2) by 10% to 15% over the next three years. Most people and businesses will be able to do much better than that with a minimal amount of effort and little or no additional costs.*
2. *Work towards achieving energy efficiency – With a quick study of our habits, we can find ways to reduce energy consumption at home and at work by measurable and meaningful amounts. A target of reducing energy use by 30% over three years is recommended as a starting point. With a serious effort, most people can do far better.*
3. *Use less water and use it wisely – The current drought conditions in many parts of the United States and elsewhere in the world have focused our attention on the importance and scarcity of water resources. Most people can reduce water usage dramatically by installing modern plumbing fixtures and paying attention to water use patterns (ie time in the shower and how long the lawn sprinklers run). Business users can save even more by evaluating processes and working toward conservation. As water costs increase, you will benefit from the conservation technologies and practices employed now.*
4. *Have an environmental management program – Processes should be investigated to determine whether there are better ways to conduct business that eliminate hazardous materials or isolate them so they are not likely to cause harm to people or the environment. Replacing underground storage tanks with aboveground tanks, and replacing chlorinated solvents with ones that are not hazardous can also save money and eliminate future problems. At home, you can also eliminate hazards that cause thousands of injuries a year and result in degradation of the environment by getting rid of unnecessary hazardous materials, by taking them to your town or regional collection centre for disposal.*
5. *Recycle solid wastes and use recycled materials wherever possible – Most people find that with a modest amount of effort, they can recycle 75% to 90% by volume of the waste materials from their homes that are currently being sent to landfills. For commercial and industrial wastes, more effort will be required, but services are available. Depending on the types of materials generated and the volumes, there may be substantial recoveries from the sale of materials that have resale markets.*
6. *Be involved in community and regional environmental and political affairs – Every business should be involved in the communities where it has operations. This will help you to stay informed on*

issues that are of interest and provide contacts that can be helpful in achieving environmental and political objectives. The communities will also benefit from the input of business leaders as well as working people that share common environmental objectives.

7. Engage in a comprehensive program of risk management – One of the foundations of sustainability is survival. Every business (and every home) is exposed to catastrophic events that can impair operations and sometimes threaten survival. Both households and businesses should have well designed and comprehensive insurance programs in place to assure that unexpected events do not destroy the enterprise or cripple its ability to perform effectively. Beyond insurance, risk management requires loss control, mitigation measures and disaster recovery plans that will lessen the likelihood of disastrous events and reduce the impact of those that cannot be prevented.
8. Measure results and report them accurately – For businesses, this advice applies to measuring financial, environmental and social results and transparency in reporting them to stakeholders, even if the news is not always good. In the home, it is equally important to keep track of information that will allow you to evaluate what you are doing today and how that changes over time.
9. Educate and involve all stakeholders in the sustainability effort – For businesses, there is little hope of being successful in operating a sustainability program that is not embraced by employees and managers at all levels of the organization. This requires clear and unequivocal endorsement of the program by top management of the organization. The same is true at home where everyone must be involved if the desired results are to be achieved. On the commercial side, education can go beyond employees to reach vendors, customers, shareholders and other stakeholders.
10. Provide adequate resources to make the sustainability effort meaningful - All worthwhile efforts take resources. Your sustainability program will require a commitment from top levels of the organization to affirm the importance of these activities to all managers and employees. You must also provide adequate resources including funding of programs where a budget is required to assure all necessary tasks are completed. At home, it is more a matter of devoting adequate time to planning and implementing sustainability strategies than spending more money.

Current and Future European Tax Policy

László Kovács is the European Commissioner for Taxation and Customs Union

The Commission's policy with regard to taxation is an integral part of its comprehensive strategy to create more growth and jobs in the EU and to boost the competitiveness of EU companies. We want to make Europe a more attractive place to invest and work by promoting knowledge and innovation. We concentrate on the improvement of a more favourable tax environment so that business and citizens can benefit from the full potential of the internal market.

Attracting investment can be done in many ways and taxation plays a part in this. At the same time, taxation touches the heart of the functioning of the Member States, ie their national budgets: they need to be able to raise the correct amount of tax so that, for instance, a cohesive and fair social infrastructure can be paid for.

Within this framework, our taxation policy aims at addressing the concerns of individuals and businesses operating within the Internal Market by focusing on the elimination of tax obstacles that companies face when they operate in several Member States. Such tax obstacles refer to, for instance, compliance costs due to the need to comply with a multiplicity of different rules, lack of cross-border relief of losses, disputes on transfer pricing issues, etc. Due to these obstacles, companies willing to operate across borders are at a disadvantage compared to companies operating in a domestic context, which is referred to in the economic literature as home bias.

At the end of December 2006, the Commission launched a new strategy with regard to direct taxation. This initiative is directed at co-ordinating and improving the performance of existing national direct tax systems by rendering these systems compatible with the Treaty and with each other. The Commission is proposing to work together with Member States and other stakeholders, where appropriate, to ensure that taxpayers will better benefit from the freedoms provided by the Treaty.

Cross-border loss relief

Cross-border loss relief provides the first example of a specific area where Member States could benefit from a co-ordinated approach.

Loss relief is a major obstacle for international companies: a lack of cross-border relief of losses may lead to (economic) double-taxation. In most Member States, domestic losses may be set-off against other profits in the same Member State. However, there is only limited availability for such relief for losses incurred in other Member States. This creates a barrier to entering other markets, distorts business decisions within the internal market and therefore undermines the international competitiveness of European companies. Companies could refrain from investing in other Member States for the simple reason that losses from domestic investments are immediately taken into account, whereas losses incurred in another Member State are excluded from such relief.

In the Marks & Spencer judgement,[1] the European Court of Justice already intervened in this debate when it obliged, under certain conditions, the Member State of a parent company to grant relief for definitive losses of a subsidiary established in another Member State.

Following this judgement, the Commission has suggested ways in which Member States may allow the cross-border relief of losses which are sustained either:

- within a company (ie losses incurred by a branch or "permanentestablishment" of the company situated in another Member State);
- within a group of companies (ie losses incurred by a group member in another Member State).

Transfer pricing

Another major tax obstacle for international companies is the existence within the EU of different transfer pricing rules for associated companies.

When associated companies trade across borders, they are obliged to use the market price (the so-called arm's length price) for tax purposes. Indeed, using another price could result in a transfer of the tax base from one country to another. However, it is not always easy for the companies or tax administrations to determine this price. For this reason, Member States have defined specific rules to determine the transfer price. These rules may differ between Member States and may therefore lead to inconsistencies in the internal market and additional administrative burdens on taxpayers, who may be taxed twice on the same income – so called double taxation.

The Commission has been very active in dealing with transfer pricing issues. In cooperation with a group of experts from the private sector and tax administrations (the Joint Transfer Pricing Forum- JTPF), we have already implemented two Codes of Conduct and have just made a proposal for guidelines to avoid transfer pricing disputes among tax administrations and taxpayers by promoting the use of Advance Pricing Agreements within the EU.

Although these Codes of Conduct are not binding instruments for Member States, Member States have committed themselves to respect them.

The first broad area looked at by the Forum was dispute resolution. The provisions of the Code on the convention for the elimination of double taxation in connection with the adjustment of profits of associated enterprises (the so-called "Arbitration Convention") aim to ensure that it would operate more efficiently and that the resolution of transfer pricing disputes should be achieved within three years of the request being submitted, unless the taxpayers concerned grant an extension.

In July 2006, based on the JTPF conclusions, the Council adopted a Code of Conduct on documentation requirements related to transfer pricing. Documentation requirements are an important topic both for the taxpayers and the tax administrations but can become a major administrative burden when 27 sets of documentation must be prepared. The code sets out, for example, a practical limit on the level of standard documentation requirements that Member States can impose as part of their domestic laws.

The third broad area examined by the Forum is dispute avoidance. In February 2007 the Commission proposed EU guidelines for Advance Pricing Agreements (APAs) between taxpayers and tax administrations. APAs are very effective tools for dispute avoidance.

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These guidelines encourage the use of APAs in order to improve legal certainty for taxpayers.

A comprehensive solution: EU common tax base

Besides these targeted measures, companies would be interested in a more comprehensive solution. Therefore, the Commission believes it is absolutely necessary to create a Common Consolidated Corporate Tax Base (CCCTB). The CCCTB will enable companies operating in the Internal Market who opt to use it to follow the same rules for calculating their tax base across the EU, rather than in accordance with up to the existing 27 systems, thereby improving efficiency and reducing compliance costs. Tax authorities would then distribute the taxable base according to pre-determined criteria.

A recent study made by KPMG underlined the expectations from business with regard to a CCCTB: nearly 80% of tax experts of leading European companies interviewed by KPMG support harmonisation and consolidation of tax bases in Europe.

The CCCTB will eliminate existing risks of double taxation and intra-community transfer price difficulties and will allow cross-border loss offsetting. This will contribute to improving EU companies' efficiency and competitiveness and significantly reduce their compliance costs and general administrative burdens.

Given that the CCCTB project does not include any action on tax rates, it would not undermine national sovereignty but would create a more transparent and simpler tax environment for companies.

Work in the Commission is being continued in order to allow companies to choose an EU-wide tax base as set out in the 2008 Commission work programme. My services are carrying out an impact assessment in order to examine the alternative policy options and their respective economic impact.

VAT one-stop-shop

With regard to VAT, tax obstacles are not as significant as in the corporate tax area given that rules are already harmonised at EU level.

However, companies doing business in several Member States and liable to pay VAT, or entitled to a refund of VAT paid, in those Member States still face administrative burdens in each of those Member States.

In 2005 the Commission made a proposal for a one-stop-shop scheme. The proposed scheme would remove the current obligation on traders supplying goods or services, taxable in another Member State, to complete VAT returns in those Member States in which the VAT is due.

Under this one-stop scheme, companies would have the option to submit their VAT returns electronically to the tax authorities of the Member State where they are established; the information on the VAT return would be transmitted automatically to the Member States of consumption (where the tax would be due); payment of VAT would be made directly to the Member States of consumption.

In addition, the proposal would allow an EU trader to present a request, via the tax administration where he is established, for a VAT refund relating to goods or services on which he has paid VAT in other Member States where he is non-established. Making the current refund procedure electronic should mean less work in the future for the refunding Member States and consequently the Commission also proposes that the processing time for requests be reduced.

In June 2007 the EU Finance Ministers reached political agreement on a VAT Package which included certain elements of the one-stop scheme and the refund to non-established EU businesses. Although these proposed changes are not as ambitious as the Commission proposal they will nevertheless reduce burdens on business. It is hoped that the measures can be adopted by the end of 2007.

My objective: removing all additional tax obstacles to cross border activities

I have given here a short overview of our priorities on tax policy. The Commission believes that there is no need for an across the board harmonisation of Member States' tax systems. From an EU perspective, according to the subsidiarity principle, Member States are free to implement the tax system they wish according to their economic and social objectives, provided that the tax system respects Community law.

However, we put all our efforts into removing the existing additional tax obstacles that companies face when they operate in several Member States. I am convinced that this will increase the competitiveness of EU companies and create more jobs and growth in the EU. ■

1. *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes): Judgment of the European Court of Justice in Case C-446/03, 13 December 2005*

Business Restructurings and Transfer Pricing: Risky Business?

Cecilie Dahle Nedrelid and Arne Jenssen of Ernst & Young Norway

Introduction

Transfer pricing - heard much about it lately? Arguably, transfer pricing is now at the top of the international tax agenda. National tax authorities increasingly focus on broadening their tax base as a response to international competition in tax rates and tax regimes. Issues arise when companies perform sound actions from a business perspective while governments view the same as shifting of profits to more beneficial tax jurisdictions.

The main allocation rule within groups of companies is the arm's length principle, which tests whether independent parties acting rationally would have entered into the same arrangements. If not, tax authorities may reject the tax returns and tax according to the income distortion caused by the group affiliation. Absent a comparable transaction, the OECD Guidelines require an analysis of facts and circumstances relevant to the parties in the transaction. Hence, the forces behind a restructuring process must be analysed. Unfortunately, as we shall see later, the practical application of this principle may be viewed differently by taxpayers and tax authorities, and may also vary from country to country. This fact implies a risk, often substantial, that decision makers should be aware of.

Globalisation produces growth

The world today changes faster than ever before and opportunities are countless. Potential customer bases expand as improved transportation and the internet reduce distances. The world shrinks and business grows. With the possibilities of such growth, companies expand across borders. As a result, large multinational companies have increased both in number and size over the later years.

When companies see business opportunities governments see taxing opportunities. The tax rate is only one part of the equation. The tax base, defining the profit subject to tax, is equally important. In the tax battle between nations, transfer pricing plays a leading role. The rules of transfer pricing determine which part of a multinational group's profit that is taxable in any particular country.

Growth leads to restructurings

As companies grow and become multinational, they also become highly complex and challengeable to manage. In many cases, a web of companies and functions are the result of rapid expansions to grow and win market shares. In order to gain control and obtain a sound business strategy for the group, the operational and organisational structure often needs to be revisited.

An efficient operational and organisational structure is not only a tool to increase revenue, but also an absolute requirement to stay competitive. Especially with regard to growth as a result of Mergers

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and Acquisitions (M&A), companies may become sub optimised. Thus, with M&A activities on the rise, we can expect a parallel rise in business restructuring as this frequently follows M&As.

Restructuring scenarios – tax issues

There are perhaps three typical business restructuring activities that may lead tax authorities in any given country to assert that a tax liability is applicable. Such taxation can have a paramount impact on the cost savings achieved by the restructuring.

Prior to restructuring		
Function:	**Norwegian Company**	**US MNE**
Plan	X	
Buy	X	
Make	X	
Move	X	
Sell		X

The first typical example would be reducing or eliminating the production capacity in one country and increasing production of the same product/product line in another country. Shifting production between locations in such manner gives rise to the question of whether a taxable asset was transferred between the two locations, and if so, what was the value of said asset.

The second activity frequently under scrutiny is the centralisation of functions and risks. An example is the transformation of a previously entrepreneurial, fully functional sales and distribution operation into a focused sales agency. In this case, the functions of marketing, strategic price setting and forecasting (among many) may be centralised. Being limited to focusing only on sales activities, this operation takes limited risk as it is no longer responsible for the risks associated with the above functions. This would then naturally reduce the operation's income, as risk and associated revenues are centralised and relocated to a different country. This commercially sound restructuring may nonetheless provoke the tax authorities into arguing that no "arm's length" company would agree to such a reduction in revenues without compensation.

The third scenario is the conversion of a "fully-fledged manufacturer" into a "contract manufacturer". A fully-fledged manufacturer may be responsible for activities related to production planning and scheduling, inventory and supply chain management, quality control strategy, long range capacity planning, and sourcing and procurement. The fully-fledge manufacturer would hence also be responsible for the associated risks, such as product liability, warranty and plant capacity risk. When restructured into a contract manufacturer, the entity only retains limited risks, for example those associated with day to day scheduling, execution of quality controls and actual manufacture of products. A contract manufacturer operates with a very limited risk and hence the restructuring has left the entity with less revenue potential. The company would then typically be rewarded on a cost-plus basis.

Business rationale is usually the driver behind most restructuring processes, not tax. However, tax efficient supply chain management (TESCM) is obviously also an important subject when it comes to business restructuring decisions. Organisations can not cut operational and management expenses indefinitely and hence TESCM has become a tool to further cut costs through minimising the amount of tax paid, based on OECD guidelines and local law. A major problem is however that all too often, tax authorities are certain that tax avoidance is the main reason behind business restructurings, frequently encouraging them to levy exit tax charges or tax on conversion gains. As this article aspires to show, the paradox is however that although TESCM may influence the set up, the need for restructuring is normally caused by the business itself and a pressure to earn money, not from a desire to save taxes.

This issue may be further enlightened by an example from a Norwegian appeal court case currently under appeal to the Supreme Court.

A US Multinational Enterprise (MNE) entered into a 50/50 split joint venture (JV) with a Norwegian competitor. The joint venture was a fully-fledged manufacturer. A few years later, the US MNE bought the remaining 50 percent of the JV, gaining 100 percent control of the company. During the following business restructuring, the previously fully-fledged manufacturer was converted into a contract manufacturer. A number of functions previously performed by the Norwegian company were thus relocated to the European distribution operation (see chart below).

After restructuring			
Function:	**Norwegian Company**	**US MNE**	**European Distributor**
Plan			X
Buy			X
Make	X		
Move			X
Sell		X	

As a result of the restructuring process, the Norwegian company, now a contract manufacturer, was left with very limited risk. After the restructuring, the Norwegian company's remuneration was decided on a cost plus basis, as is typical for contract manufacturers. This led to a gradual reduction in the Norwegian company's taxable income.

Some of the differences in profit may be explained by the transfer of risk and associated income. According to the OECD guidelines, risks should be attributed to the entity which has the highest potential of controlling the risk in question. Therefore, as the European distributor after the restructuring performed planning, buying and moving, the associated risks should also be attributed to this company. And, as economic theory implies, when taking additional risk, the European distributor should be rewarded through an increased share of the potential profits. This is also in accordance with the "arm's length principle", as few if any independent companies would agree to take on risks without compensation.

The dispute between the company and the government in this case is however if the restructuring decision was sound from a business perspective for the Norwegian company. In particular, the relevant issue is whether income-generating intangibles were transferred away from the Norwegian company without this company being compensated for a sale of said intangibles.

From a business perspective, the restructuring seen as a whole constituted a commercially sound business decision, focusing on optimisation, removing duplication and reducing costs. No other group company received the intangible; the group of companies considered it simply a duplicate. In an environment of changing market conditions, the Norwegian company traded its position of uncertain profit to that of a certain profit. With the trade came fewer areas of responsibility.

To the Norwegian tax authorities the restructuring represented a simple taxable transfer of intellectual property rights as well as a significant part of the business. Since this transfer had not been compensated, the Norwegian entity was hit with a MUSD 60 income charge.

One of the main lessons from this case is that having good contemporary documentation of the business rationale for the restructuring, underpinned by intra-group contracts and other documentation is key to minimizing conversion risk. The fact that transfer pricing is high on the audit list of most tax authorities is a clear warning.

So what to do? Since rules and the practice of tax authorities vary from country to country, local advice is necessary prior to any implementation. After implementation, all relevant information explaining the business rationale should be put in writing and relevant agreements prepared or collected in order to be readily available if an audit comes up. It is generally an uphill battle for the tax authorities to attack a well prepared tax payer who can demonstrate and document the business rationale upon request.

Transfer pricing – legal development in Norway

The rules of transfer pricing are currently becoming regulated in an increasing number of countries. In Norway, the OECD Guidelines have recently been included as Norwegian law, in force from January 1, 2008. Although the Guidelines have been applied in Norway for many years after rulings of the Supreme Court, the new legislation marks a change in the focus on transfer pricing. As is the case for so many other countries, Norway is a country reasonably immature in this respect. The laws still have holes and flaws, resulting in some degree of uncertainty for companies facing restructuring challenges. Also, from 2007, qualified companies must file a transfer pricing overview together with their tax filings. From 2008, extensive formal documentation rules apply as well. Hence, Norway is joining the long list of countries with an extensive transfer pricing regulation. ■

First-Time Luxembourg – Hong Kong Tax Treaty Signed

Dirk Leermakers is Managing Partner at Loyens Winandy

On 2 November 2007, Luxembourg and the Hong Kong Special Administrative Region of the People's Republic of China ("Hong Kong") entered into an agreement for the avoidance of double taxation and the prevention of tax evasion with respect to taxes on income and capital (the "Treaty").

The signed Treaty must be ratified in both countries before it enters into force. Once in force, the Luxembourg - Hong Kong treaty will apply for tax periods starting on or after 1st January 2008 in Luxembourg and for tax periods starting on or after 1st April 2008 in Hong Kong.

With Thailand, China and Belgium, Luxembourg will be the fourth state with a treaty with Hong Kong for the avoidance of double taxation and the prevention of tax evasion. The Treaty, once in force, allows investments from Hong Kong into Europe in a way that profits can be repatriated to Hong Kong without withholding tax. Luxembourg may therefore play an important role in structuring such investments between Hong Kong and Europe.

The Treaty broadly follows the OECD Model Convention, with some provisions however based on the UN Model Convention. Below the main features of the Treaty are summarised.

Eligibility to the Treaty

The Treaty applies to "persons" that qualify as residents of either Hong Kong or Luxembourg (each a "Contracting Party"). The term "person" includes an individual, a company, a partnership and any other body of persons. The term "person" also applies to Hong Kong trusts.

In the case of Luxembourg, "resident" means inter alia any person who is liable to tax by reason of his domicile, residence or place of management.

In the case of Hong Kong "resident" means inter alia:

- any individual who ordinarily resides in Hong Kong;
- any company incorporated or normally managed or controlled in Hong Kong;
- any other person constituted under the laws of Hong Kong or being normally managed or controlled in Hong Kong.

The government of a Contracting Party or any local authority thereof also qualifies as a resident.

The Treaty does not contain a specific "limitation on benefits provision". Thus, non-Luxembourg or non-Hong Kong residents may indirectly take advantage of the Treaty benefits by investing through a Hong Kong or Luxembourg resident.

Taxation of income

Income from immovable property

Income derived from immovable property may be taxed by the Contracting Party in which the immovable property is situated.

Business income

Income derived from an enterprise of a Contracting Party may only be taxed in that Contracting Party, unless such income is derived through a permanent establishment situated in the other Contracting Party. Such income may be taxed in that other Contracting Party as well, but only to the extent it is attributable to that permanent establishment. The definition of "permanent establishment" includes a building site or a construction, assembly, installation project or supervisory activities carried out in connection therewith if the activity lasts for at least 6 months; and furthermore services, including consultancy services, that are furnished by an enterprise directly or through employees or other personnel engaged by an enterprise for such purpose but only if activities of that nature continue (for the same or a connected project) for a period or periods aggregating more than 180 days within any twelve month period.

Dividends

Dividends paid by a company resident in one Contracting Party to a resident of the other Contracting Party may be taxed in that other Party. Such dividends may also be taxed in the Contracting Party of which the paying company is a resident, however, if paid to a beneficial owner resident in the other Contracting Party, such taxation may not exceed:

- 0 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends or a participation with an acquisition cost of at least EUR 1.2 million in the company paying the dividends;
- 10 per cent of the gross amount of the dividends in all other cases.

Interest

Interest is only taxable in the Contracting Party of which the beneficial owner is a resident.

Royalties

Royalties paid by a company resident in one Contracting Party to a resident of the other Contracting Party may be taxed in that other Party. Such royalties may also be taxed in the Contracting Party of which the paying company is a resident; however, if paid to a beneficial owner resident in the other Contracting Party, such taxation may not exceed 3% of the gross amount of the royalties.

The definition of royalties includes among other things any copyright of literary, artistic or scientific work including cinematograph films or payments for the use of, or the right to use industrial, commercial or scientific experience.

Capital gains

Capital gains may, generally speaking, only be taxed in the Contracting Party in which the alienator is a resident, except if the alienated asset qualifies as:

- immovable property situated in the other Contracting Party;
- movable property allocated to a permanent establishment in the other Contracting Party; or
- shares of a company more than 50% of the value of which is derived directly or indirectly from immovable property situated in the other Contracting Party (with exceptions applying to shares (i) quoted on certain stock exchanges; (ii) alienated in the framework of a reorganisation, merger, division or similar operation; and (iii)

- in a company deriving more than 50% of its asset value from immovable property in which it carries on its business).

In these cases the Contracting Party in which the immovable property or the permanent establishment is situated is entitled to tax the capital gains.

Income from employment

Income from employment may be taxed exclusively in the Contracting Party of which the employee is a resident, unless the employment is exercised in the other Contracting Party. In the latter case the income from employment may also be taxed in that other Contracting Party subject to the so called 183-days rule.

Director's fees

Director's fees may be taxed in the Contracting Party of which the company, in which a director's or similar function is exercised, is situated.

Pensions

Pensions or other similar remuneration may in principle only be taxed in the Contracting Party of which the recipient is a resident, but if paid under (i) a public scheme which is part of the social security system of a Contracting Party; (ii) a scheme in which individuals may participate to secure retirement benefits and which is recognised for tax purposes in a Contracting Party; or (iii) the social security legislation of a Contracting Party shall be taxable only in that Contracting Party.

Other income

Items of income not dealt with in the specific articles of the Treaty and derived from sources in a Contracting Party may be taxed by that Contracting Party. Other items of income not dealt with in the specific articles of the Treaty may in principle exclusively be taxed by the Contracting Party of which the recipient is a resident.

Capital

Capital represented by immovable property or by movable property forming part of the business property of a permanent establishment may be taxed by the Contracting Party in which the immovable property or the permanent establishment is situated. Other capital may normally only be taxed by the Contracting Party of which the owner is a resident.

Methods for elimination of double taxation

Hong Kong avoids double taxation by applying the credit method.

Luxembourg avoids double taxation in the following manners:

- For income derived from sources that may be taxed in Hong Kong (inter alia (certain) dividends and royalties) Luxembourg will allow a credit against Luxembourg tax for Hong Kong tax up to the amount of Luxembourg tax on such items of income;
- For other income that may be taxed in Hong Kong and derived by a Luxembourg tax resident, Luxembourg shall provide an exemption from Luxembourg tax, unless Hong Kong applies the Treaty such that Hong Kong exempts such income.

Miscellaneous provisions

The Treaty contains a non-discrimination clause, provisions for a mutual agreement procedure and provisions for the exchange of information between the two Contracting Parties.

The Treaty furthermore explicitly stipulates that it does not prevent Luxembourg or Hong Kong from applying its respective domestic laws and measures concerning tax avoidance, whether or not described as such.

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Key German Transfer Pricing Trends

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1. Introduction

In nearly every tax audit in Germany, of taxpayers with cross-border transactions, transfer pricing issues are covered and transfer prices are scrutinized. German tax authorities still spend a lot of effort in training their tax auditors in the transfer pricing area.

Further, the 2008 German tax reform seeks a comprehensive overhaul of the German tax system. The objectives of this tax reform are to improve Germany's position in global competition and to avoid profit shifts to other tax jurisdictions for tax planning purposes.

The new bill includes a reduction of the combined corporate and trade tax rate for corporations by approximately nine percentage points. Additionally, the bill introduces several counter measures to increase the tax basis. The most notable counter measures are the General Interest Expense Disallowance Rule which is governed by Section 4h of the Income Tax Act and changes regarding transfer pricing in Section 1 of the Foreign Tax Act. The following summary highlights in particular the new rules on transfer pricing.

2. Legislative and administrative developments

2.1 German Business Tax Reform 2008, here: new transfer pricing rules

The law includes new transfer pricing legislation especially relating to the transfer of business functions to other tax jurisdictions. The German government's aim is to ensure that strict rules exist regarding transfers of business functions and business restructurings.

To provide guidance on compliance and in an effort to make the new regulations more administrable, the German Finance Ministry will additionally release i) Executive Order Laws binding for taxpayers, tax authorities and tax courts, and ii) Administration Principles binding tax authorities. On June 4, 2007 the Federal Ministry of Finance (BMF) published a first draft of the Executive Order Law on the transfer of business functions. A further Executive Law dealing with the arm's length principle is to be expected for spring 2008.

The following highlights of the legislation (amendment of Section 1 Foreign Tax Act, which is going to be effective for the tax assessment period 2008) will be emphasized below and include:

- a general definition of the arm's length principle, as well as significant details on the determination of transfer prices and the use of ranges for profit level indicators in the absence of internal or external comparables, eg the use of the interquartile range of identified values;
- business restructurings (relocation of functions); and
- transfer pricing adjustments (a kind of commensurate with income approach).

Arm's length test

In the new Section 1 subs. 1 Foreign Tax Act it is stated that for the application of the arm's length principle it is assumed that unrelated parties are aware of all essential circumstances of a transaction and act on principles of a *prudent and diligent business* manager at the time of the relevant transaction. This sound and prudent business manager test is especially important for the new interpretation of the *hypothetical arm's length test*. If comparable data cannot be determined, because neither fully nor limited comparable data is available, the hypothetical arm's length test shall be used (Section 1 subs. 3 sentence 5 Foreign Tax Act).

If fully comparable data is available the transfer price for an intercompany transaction shall be determined primary using this data and one of the transactional transfer pricing methods (the comparable uncontrolled price method, the resale price method or the cost-plus method). If only limited comparable data (eg gross margins, mark-up on costs) is available, this data shall be used for the determination of the transfer prices using an appropriate ▸▸

Transfer pricing can make a valuable contribution to the performance of a company. But only if legal and fiscal aspects are given due consideration. We have built up a global network of 800 transfer pricing professionals around the world. Our focus is on multinational companies (inbound/outbound) and their intragroup transactions. We provide advice on the arm's length evaluation of those transactions as well as on the tax effective design of arm's length transfer pricing systems.

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transactional transfer pricing method. Additionally, in this latter case, if more than one limited comparable data were identified, a range has to be determined. This range of limited comparable data, however, shall be narrowed. When the price, used by the taxpayer is in cases of full comparability of data outside the range or in cases of limited comparable data outside the narrowed range, the median shall be applicable.

When performing a hypothetical arm's length test a so-called range of potential agreement will be determined. This range of potential agreement will be the result of the performance of analyses of functions and risks and internal financial planning by forecasting of the profit expectations in the relevant transaction (profit potentials). The range will be cornered by the maximum price a fully informed diligent buyer would pay and the minimum price a fully informed diligent seller would accept. It is important to note that the determination of the price is not only conducted from the view of the seller/provider or the buyer/recipient but both. This means that in practice (eg transfer of intangible assets) two valuations have to be conducted. It is implied that all relevant circumstances of a transaction are well known even among unrelated parties, so complete transparency and information is given. Based on that it is expected that a taxpayer does not only make use of its own information but also knows about and exploits the information of the other contracting party in evaluating the value of the business function, which is subject to the transfer.

The price which complies with the arm's length principle with the utmost probability shall be used as transfer price for the transaction. If a taxpayer does not substantiate a certain price within the range of potential agreement the mid-point between the two values is deemed to be the price the two prudent business managers would have agreed on. The presumption of the mid-point is deemed to be the price the two prudent business managers would have agreed on. The presumption of the mid-point is deemed to simulate the outcome of fictitious negotiations between unrelated parties.

Business restructuring (relocation of functions)

The government not only intends to tax situations where intangibles are relocated to an associated enterprise or permanent establishment in another tax jurisdiction, but under the new law, it is sufficient if mere advantages or profit expectations that cannot be regarded as intangible assets will be transferred abroad. According to the new Section 1 subs. 3 sentence 9 Foreign Tax Act in connection with the first initial draft Executive Order Law a shift of functions is assumed, if a function together with its related chances and risks as well as advantages (a so-called transfer package) is transferred or surrendered between affiliated companies. Additionally, the first initial draft Executive Order Law shall apply to so-called functions that are duplicated, ie when "without restriction of the previous business activity, a related entity assumes a function performed by the former entity using its assets and advantages"[1]. In this case, the principles for taxation of the shift of functions are to be applied also for the duplication of functions according to the arm's length principle. Thus, a transfer of functions is assumed for tax purposes even if the functional profile of the German transferor does not change at all. This draft provision causes very controversial discussions and one can be anxious about it whether this rule will find its way into the final Executive Order Law.

Basically a payment for the transfer of a function has to be calculated for the transfer of a function as a whole. This means a valuation of the (whole) transfer package has to be made. The transfer package could consist of assets and other advantages. A payment would then be calculated based on the differences in projected profits of the German affiliate and the affiliate receiving the function, ie the discounted/capitalized earnings value of the transferred profit potential. The profit expectation related to the transfer package is to be determined both from the view of the transferor and the transferee. As mentioned above, this means that in practice two valuations have to be conducted. Compensation would have to be paid not only in cases where intangibles were transferred, but also if advantages in the form of profit potential are transferred, as mentioned above. In certain exceptional cases a valuation of each single asset is allowed, eg if no valuable, essential intangible assets is transferred.

The law also introduces the interquartile range concept into legislation and requires an income adjustment by the tax authorities to the median (as the arm's length value) if the price the taxpayer has agreed on is outside the range of arm's length prices.[2] Previous decisions of the Federal Tax Court only allowed adjustments to the end point of the range that was most beneficial to the taxpayer.

The new legislation also introduces the concept of the hypothetical comparison for those cases where no internal or external comparable data is available. In case of no comparables the so-called "agreement range" of the transfer package price is to be determined by the hypothetical arm's length principle. A hypothetical comparison means considering the range between the maximum price a fully informed diligent buyer would pay and the minimum price a seller would accept. Generally speaking, the arm's length price should then be the most probable value within that range, which is generally deemed to be the mid-point between the two. However, the latter can be disproved by the taxpayer. The overall effect of this approach is that, for example, synergy effects and location savings may be "split" between the parties involved in the transaction.

The German transfer pricing legislation imposes a "commensurate with income" standard that will apply to the relocation of material/essential intangible assets and functions if the actual profit development differs substantially from the forecasted profit development that was the basis for the estimation. It will require multinational corporations to agree on adjustment mechanisms for a payment made to German affiliates for the transfer of functions unless the taxpayer provides strong arguments that such adjustment mechanisms are not arm's length.

This hypothetical pricing adjustment mechanism is introduced with the rebuttable presumption that at the time when the transaction was concluded uncertainties concerning the price agreements existed and unrelated parties would have agreed to an appropriate pricing adjustment mechanism.[3] This will allow tax authorities to perform a price adjustment (in case of a transfer of essential assets and opportunities) in case of a significant deviation of actual business developments and results from the forecast (assumptions and budgets) used to calculate the transfer remuneration, for a period of 10 years after the transfer. A significant deviation is deemed to exist if the actual value of a transaction is outside the agreement range. Such an adjustment can only be made once. According to the proposed law, an appropriate one-time adjustment amount that amends the original transfer price has to be calculated in the year subsequent to the year in which the deviation took place. This also means that only one and the first substantial budget deviation can be "corrected". Further budget deviations cannot lead to further recalculations of the remuneration.

The application of the pricing adjustment provision can be avoided if the taxpayers agreed about an arm's length adjustment provision on their own.

Further amendments

Under current transfer pricing documentation requirements, documentation for extraordinary business transactions must be prepared contemporaneously. The deadline to submit such documentation was now shortened to 30 days[4] after a tax auditor's request from the current 60 days because due to the obligation for contemporaneous documentation such documentation should be available anyway. Additionally, the law allows the tax authorities to estimate the taxpayer's income if information and documents cannot be received from related parties. Furthermore, there are some changes of the Executive Order Law with Regulations on the Type, Content and Scope of Documentation as understood in Section 90 (3) of the General Tax Act (Abgabenordnung), November 13, 2003, which relate to the definition of extraordinary transactions, the exemplary mentioning of deemed extraordinary transactions such as restructurings and cost contribution arrangements as well as the necessity to have a detailed documentation for research & development activities which could be connected to a change in functions/function transfers.

Further completely new debt-financing rules (so-called "interest barrier" rules) and rules to restrict the use of losses are introduced.

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2.2. Administrative developments – expected further regulations

The German tax authorities started to continue their work on Administration Principles regarding the transfers of business function between related companies some years ago. This work has been postponed now because of the legislative change that was enacted with the Legislation for 2008 (see above). Now, as mentioned above, a draft public circular on the transfer of business functions was expected in autumn 2007, but no new draft circulars were published so far.

In addition, the Federal Ministry of Finance has started to work on the amendment of the Administration Principles relating to the Allocation of Income in the Case of Permanent Establishments of Internationally Operating Enterprises (Administration Principles – Permanent Establishment), dated December 24, 1999. This circular requires some adaptation not only because of the recent changes of the German tax law, in particular as far as the transfer of assets between permanent establishments abroad is concerned.

3. New Published Circulars

3.1. Updated Note of the Federal Ministry of Finance on Mutual Agreement Procedures and Procedures under the EU-Arbitration Convention

On July 13, 2006 the German Federal Ministry of Finance issued an updated Note on Mutual Agreement Procedures that allows the taxpayer to avoid double taxation and to resort to the competent authorities if, pursuant to a transfer pricing adjustment made by the German tax authorities, the other country's tax authority is willing to offset such adjustment by making a correlative adjustment. In the new note the administrative competence for mutual agreement procedures has been centralized at a federal level in the Federal Central Tax Office (BZSt), which is the competent authority. The note updates the previous guidelines to regulate the procedural framework of the mutual agreement procedure. In general, the competent authorities are willing to negotiate and use their best efforts to eliminate the double taxation, but are not obliged to achieve a result.[5] This is different in mutual agreement procedures under the European Arbitration Convention amongst the member states of the European Union are obliged to resolve disputes where double taxation of income due to the adjustments of profits of associated enterprises and the adjustment of profits attributed to permanent establishments are concerned. The new note describes the process and procedural rules on the arbitration procedure. It also includes provisions regarding the publication of the opinion of the so-called advisory commission and the response of the competent authorities, taking into consideration the confidentiality and discretion needs in German tax matters.

3.2. Note of the Federal Finance Ministry on Advance Pricing Agreements (APA)

The German Ministry of Finance issued a Note on Bilateral and Multilateral Advance Mutual Agreement Procedures based on the Mutual Agreement Procedure Provisions of Germany's Tax Treaties (so-called "Advance Pricing Agreements" – APAs) on October 5, 2006 which defines the APA procedures and provides guidance with regard to the negotiation of APAs. In terms of content and application the German principles in general correspond with common international and OECD standards. The administrative competence for APAs is centralized in the Federal Central Tax Office, the BZSt. The BZSt has published a list of information and documents that have to be included and annexes that should be attached to the written application. The taxpayer must also pay a fee. The APA process typically takes from 1.5 years to several years from application to conclusion. Depending on the case it is expected that the APA term is usually between three to five years. However, the taxpayer may apply for a longer term. The earliest start date of the APA is the beginning of the business year in which the tax authority receives the application. Under certain conditions they may also refer to previous years (a rollback). An agreement reached between the two competent authorities will be made conditional in two regards, the taxpayer must consent to the intergovernmental agreement and must waive its right to appeal against tax assessments to the extent they are in line with the contents of the APA.

Overall, the note provides valuable guidance to taxpayers seeking certainty about their intercompany pricing policy. If the tax administration makes available sufficient personnel resources to accommodate the flow of applications APAs could well become a popular mean of managing transfer pricing risks.

4. Closing remarks and outlook

German tax authorities are working heavily on completing their specific regulatory framework on transfer pricing which shows again the outstanding importance of transfer pricing in Germany. Besides its tax planning opportunities transfer pricing, therefore, is in particular a risk management issue that requires taxpayers to focus particularly on the compliance area, ie to prepare and maintain comprehensive transfer pricing documentation, as well as to utilize eg APAs as an appropriate tool of (in advance) dispute resolution. With the recent legislative developments together with tax authorities becoming more and more sophisticated in approaching transfer pricing issues, the "good old times" of bargaining about a constructive dividend in a tax audit are irrevocably over. ■

1 *Section 1 subs. 4 sentence 1 FVerlagV-E*
2 *Section 1 subs. 3 sentence 4 Foreign Tax Act*
3 *Section 1 subs. 3 sentence 11 Foreign Tax Act*
4 *Section 90 subs. 3 General Tax Act (Abgabenordnung)*
5 *There are few exceptions under which Germany is obliged to put a tax dispute to arbitration. This clause is included in the new tax treaty Germany and Austria. A ratification for an equivalent amendment to the tax treaty between Germany and the United States is expected soon.*

How You and Your Organisation Can Benefit From Financial Services in Guernsey

Peter Niven is Chief Executive of GuernseyFinance, the promotional agency for the Island's finance industry

Both for you personally and your organisation there are potential benefits to be gained from using financial services in Guernsey.

Over the last four decades Guernsey has established itself as a leading international finance centre with the highest reputation and standards, providing an extensive range of products and services to a global market. The Island's mature, innovative and service-oriented financial services sector is based on a balanced range of providers, broadly comprising: insurance; banking; investment funds; and fiduciary services (trust and company administration).

Guernsey's financial services industry offers you potential benefits, whether in the management of your personal wealth or covering your organisation's risks.

How your organisation can benefit from insurance in Guernsey

Guernsey's international insurance industry provides a range of risk management solutions but is particularly renowned for its captive expertise.

Captive insurance is effectively self-insurance. In its purest form, it is where a company (the captive) is set up by its owners primarily to insure the risks of its parent (and/or subsidiaries). This can offer several

advantages in comparison with insuring through the commercial market:

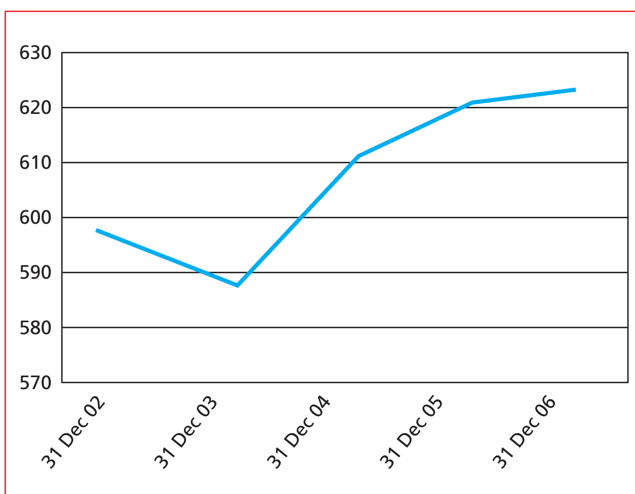
- The insuring of unusual or catastrophic risks or multiple small risks
- Premiums that relate to the insured's previous claims record
- Avoid subsidising large overheads and profit margins of commercial underwriters
- Direct access to the wholesale reinsurance market
- Benefit from the investment return on retained premiums
- Retention within the group of the excess of net premiums over claims
- Taxation efficiencies
- Improved risk management and understanding of the cost of risk

Many large public and international organisations have assessed how these potential advantages apply to their operations in practice and subsequently abandoned the commercial market in favour of establishing a captive.

Figure 1a

	Number of International Insurers			
Date	Captives	PCCs/ICCs	Cells	Total
31 Dec 02	332	50	214	596
31 Dec 03	326	57	206	589
31 Dec 04	314	65	232	611
31 Dec 05	315	67	239	621
31 Dec 06	312	69	243	624

Figure 1b
Number of international insurers



However, small to medium sized enterprises have found that the benefits of a captive, given the likely volume of business, can be outweighed by the start-up and on-going costs. Participating in a 'rent-a-captive' scheme offers the advantage of sharing those expenses but firms are cautious about doing so in a conventional company, where all of the assets and liabilities are linked and thereby risk that the failure of one insurance programme will lead to the loss of assets relating to another.

In response, Guernsey pioneered the Protected Cell Company (PCC) – a company made up of a core and individual cells, where the legal segregation ensures that no claim against one cell will be covered by the assets within another. Several jurisdictions, including Guernsey, have also now introduced the Incorporated Cell Company (ICC). An ICC, like a PCC, has cells but they are separately incorporated and distinct legal entities, offering an added layer of protection in the separation of assets and liabilities.

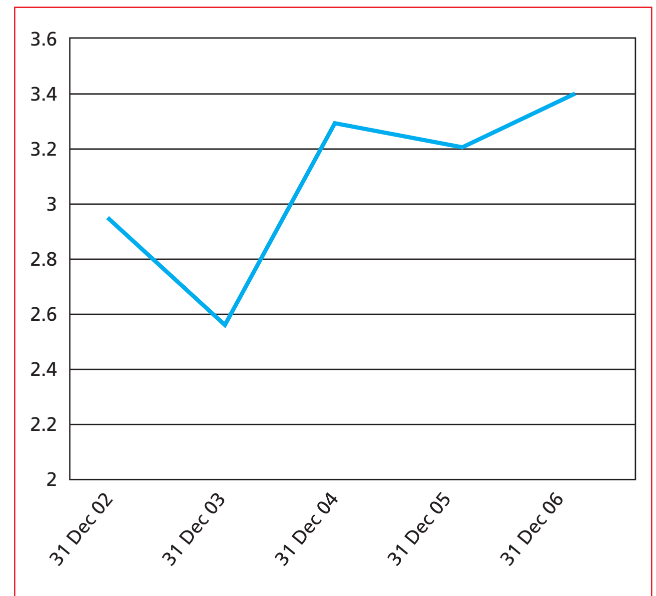
Figure 2a

Date	Authorised managers	Gross assets, net worth, premiums (£bn)		
		Gross assets	Net worth	Premiums
31 Dec 02	30	12.2	4.5	2.9
31 Dec 03	29	13	5.3	2.5
31 Dec 04	28	14.7	5.8	3.3
31 Dec 05	28	14.8	5.6	3.2
31 Dec 06	27	18.8	6.5	3.4

The use of a third-party cell company rather than a full-blown captive has distinct benefits which for SMEs, in particular, makes captive insurance far more viable:

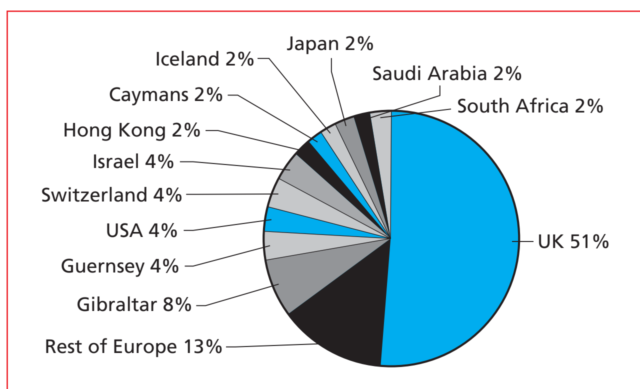
- Savings from reduced reporting requirements and shared costs
- Reduction in the amount of executive time required by the cell owner
- Quicker and cheaper to set up and exit due to different legal processes
- Need to cover the minimum margin of solvency and the risk gap but this may be less than the £100,000 minimum required for a separate captive
- Using a PCC can reduce the tax burden, for example in the UK it is possible to avoid being subject to Controlled Foreign Company legislation

Figure 2b
Value of premiums written (£bn)



There is growing recognition of the benefits of captive insurance, as evidenced by the continuing rise across the globe in the number of captive, PCC/ICC and cell formations.[1] However, in the words of Andrew Tunnicliffe, Group Managing Director, Business Development, Aon Global Risk Consulting: "there is still a long way to go before companies are truly managing risk effectively...you are missing out on significant cost savings by not using captives as part of your risk management programme."[2] Such are the potential benefits of captive insurance for all sizes of organisation that an insured's risk management strategy could be considered somewhat deficient in scope and responsibility if it does not involve the use (or at least consideration) of some form of captive insurance.

Figure 3a
Source of Captives, PCCs, ICCs and Cells Licensed in 2006 (%)



Many jurisdictions around the world offer captive insurance, including the use of the cell company.

However, it is Guernsey which can boast the richest heritage in these areas: since the first captive was established in Guernsey in 1922, the Island has grown to become the leading jurisdiction in Europe for captive insurance and number four in the world in terms of premiums written (see figures 1a & 1b and 2a and 2b); and in 1997 Guernsey pioneered the cell company with the innovation of the PCC and this has since been followed by the introduction of the ICC.

Figure 3b
Source of Captives, PCCs, ICCs and Cells Licensed in 2006 (%)

UK	51	Hong Kong	2
Rest of Europe	13	Caymans	2
Gibraltar	8	Iceland	2
Guernsey	4	Japan	2
USA	4	Saudi Arabia	2
Switzerland	4	South Africa	2
Israel	4		

This experience means Guernsey has accumulated a great wealth of related expertise. The Island now plays host to captive managers ranging from small boutique operations to large international players and independent captive managers through to broker-tied managers. They manage captives with parents from around the world, although it is from the UK where the majority of business is derived (see figures 3a and 3b). Approximately 40% of the FTSE 100 companies have captives in Guernsey and a report published in March 2007 by Marsh showed that 50% of the captives established by UK companies are based in Guernsey.[3]

Captive insurance provides your organisation with an opportunity to benefit from the financial services that are on offer in Guernsey. But what potential benefits are there for you as an individual?

How you as an individual can benefit from financial services in Guernsey

Private clients can benefit from the Island's excellence in wealth management – banking, investment funds and fiduciary services.

Banking

Banks have played a key role in the development of Guernsey as a top tier international finance centre. The first bank to be established on the Island was the Guernsey Savings Bank, which was founded in 1822. However, banking in Guernsey was purely domestic and largely conducted by the major British high street clearing banks until the mid-1960s when a clutch of merchant banks established subsidiary operations in the Island to relay the benefits of offshore banking to their international clients.

Today, there are 50 licensed banks in the Island with deposits of more than £112bn – up 26% year on year. Products range from retail banking and savings through international wealth management to institutional business and specialist lending. This includes servicing the other financial services sectors on the Island.

Banks do not deduct interest at source so taxpayers can defer their tax payable on interest earned until the end of the year. Interest earned on Guernsey accounts should be declared to the tax authorities where the depositor is resident for tax.

Banks in Guernsey have continued to perform strongly despite the turbulence in the global markets, something which is also true of the Island's investment funds sector.

Investment funds

The value of funds under management and administration is now in excess of £164bn – an increase of 36% during the year. The sector is benefiting from a series of changes that have made it quicker and simpler to conduct business in the Island.

Guernsey plays host to a range of investment businesses including investment advisers, stockbrokers, and a significant number of fund managers, custodians and administrators, who in combination offer a range of products and services for both retail and institutional investors from the general to the more specialised. In particular the Island is growing a reputation as a centre of excellence for alternative investments like funds of hedge funds, private equity and property, as well as more esoteric asset classes such as fine wine, fine art and timber.

Another area of expansion is the asset management sector. Subsidiaries of large groups as well as independent investment boutiques provide wealthy private clients, their advisers and the institutional marketplace with services, including stockbroking and dealing arrangements, for funds and discretionary investment management portfolios.

Fiduciary services

Guernsey is a leading international fiduciary centre with over 50 years experience of supplying trust and corporate services.

The Island plays host to some 140 licensed fiduciaries, ranging from large organisations to independent, boutique operations, holding more than £200bn of assets in trust. There is substantial expertise in using the innovative modern structures that are available on the Island for the preservation of both institutional and individual/family wealth and assets. In particular, Guernsey is growing an excellent reputation in the emerging niche market of the family office, where it can build on its track record of providing trust services for individuals and families.

Non-Guernsey income (and Guernsey bank interest) accruing to trusts that have no Guernsey beneficiary is not subject to Guernsey income tax.

Amendments to the Island's Trust Law, which include abolishing the personal liability of directors in Private Trust Companies (PTCs) and introducing Purpose Trusts, are expected to be introduced early in 2008. Work continues on the introduction of Foundations. Such changes ensure that providers based in Guernsey can continue to offer clients the very widest range of products and services.

On-going enhancement

The Island's already business-friendly environment is also being enhanced in other ways: on 1 January 2008, the Island will move to a standard zero rate of corporate tax (and there is already no withholding tax on dividends paid, no capital gains tax, no inheritance tax and no value added or general sales tax); a new Companies Law is set to come on-stream during 2008 – it will introduce a streamlined company incorporation process that from the summer of 2008 will be facilitated by a modernised Company Registry; and also during 2008, a suite of IP-related legislation will continue to be introduced to the market.

Guernsey already boasts an independent stock exchange, the Channel Islands Stock Exchange (CISX) – which has more than 2,000 listings; a bespoke professional development facility, the Guernsey Training Agency (GTA) University Centre, which ensures that the high standards of client service are maintained; a network of legal, accounting, tax, audit and actuarial advisers; and an independent regulator, the Guernsey Financial Services Commission (GFSC), with its robust yet pragmatic approach to regulation. Indeed, it is through scrutinisation and endorsement from third parties such as the ▸▸

International Monetary Fund and the Financial Action Task Force that Guernsey can justify its claim to be a well regulated and first-class international finance centre.

Whether the management of your personal wealth or covering your organisation's risks, Guernsey's financial services industry can offer you potential benefits.

1 *The Journal, the magazine of the Chartered Insurance Institute, reports in the October, 2007, article 'Capturing Interest' that there are some 5,000 captives globally, writing more than $20bn in premium and with a capital and surplus at more than $50bn. Andrew Tunnicliffe, Group Managing Director, Business Development, Aon Global Risk Consulting says that the report, Global 1500: A Captive Insight 2007, published in summer 2007 by his firm, "shows that growth in the captive market is not slowing down." http://insight.aon.com/?elqPURLPage=612*

2 *Andrew Tunnicliffe, Group Managing Director, Business Development, Aon Global Risk Consulting, commenting on the report, Global 1500: A Captive Insight 2007, published in summer 2007 by his firm. http://insight.aon.com/?elqPURLPage=612 It notes that insurance buyers within the world's largest companies are failing to achieve a better quality of cover as well as cost savings of typically 10-15%, through economies of scale, efficient use of capital, leverage and more efficient use of senior management time.*

3 *Fit for Purpose? Benchmarking the Continuing Contribution of Captives, from Marsh UK, March 2007.*

Guernsey factfile

Guernsey, situated 30 miles west of northern France and 70 miles south west of England, is 24 square miles in size and has a population of 60,000. The Island is a British Crown Dependency, with over 800 years of self-government. It is legislatively and fiscally independent of the United Kingdom and has its own democratically elected parliament, the States of Guernsey.

Guernsey also enjoys a special relationship with the European Union. Terms negotiated on the UK's accession to the EEC mean that the Bailiwick is within the Common Customs Area and the Common External Tariff; essentially it enjoys access to EU countries for physical exports without tariff barriers. Other rules and directives do not apply though, unless voluntarily accepted.

The Island is English speaking; uses British Pound Sterling; is in the same time as the UK; and is in close proximity to and has regular air links with London and Europe.

The CISX – A Very International Exchange

Tamara Menteshvili is the Chief Executive of the Channel Islands Stock Exchange

There is no doubt that the CISX has gained wide international acceptance – as the approval of its 2000th listing in April 2007 confirms, and with a further 25% increase in listings since that time.

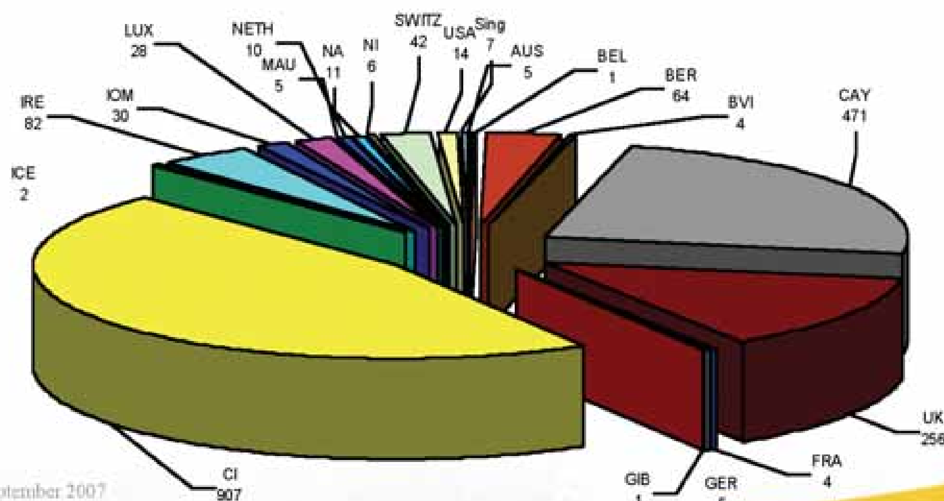
The CISX has several unique selling points - not least is its efficiency and quick turnaround time. Indeed, this feature was one of the reasons why the CISX was voted Best Offshore Stock Exchange in 2006 for the second year running by readers of Investment International. For example, in the fast-paced Eurobond market, an efficient service is not only highly desirable but often necessary. The Market Authority is highly responsive to this requirement and meets daily to approve admission to the Official List.

The CISX is in a unique position being outside the European Union but within the strategic European time zone and with the added benefit of widely held international recognition. The Listing Rules favour a disclosure regime rather than featuring a long list of prohibitions. Flexibility is what product designers are looking for and that is what the CISX offers. However, flexibility does not come at the expense of high standards.

The Exchange's infrastructure and Listing Rules has gained the Exchange formal recognition from some of the world's leading economies, such as the US and UK. That recognition includes the US Securities and Exchange Commission, which granted the CISX Designated Offshore Securities Market under Regulation S; HM Revenue and Customs under section 841 ICTA and the UK's Financial Services Authority (FSA), which granted the CISX Designated Investment Exchange status.

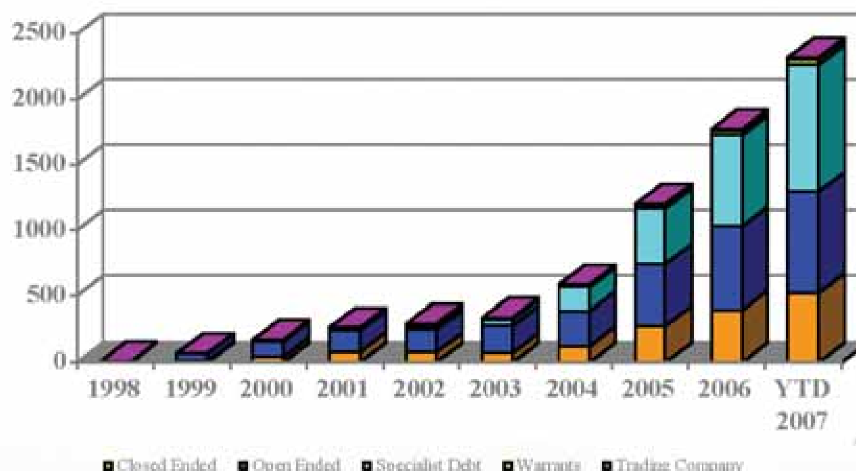
The Market Authority accepts a wide range of legal structures for admission to the Official List, including protected cell companies and limited partnerships. With regard to the specialist debt sector, the Market Authority recognises that such securities are typically targeted at institutional investors, thus it approaches the listing of specialist debt securities in a very pragmatic way. Disclosure of information is kept to a minimum, focusing on the key features of the debt issuance programme or debenture, the terms and conditions of the issue and, in the case of asset-backed securities, the underlying assets.

The types of specialist debt securities listed on the CISX include, Eurobonds, Tier One Capital, Corporate Debt, Special Purpose Vehicles, Mult-Issuer Programmes, Derivative Warrants – the list goes on.



The Market Authority combines a pragmatic and flexible approach with responsibility in delivering a high quality, professional service. The Exchange offers a full listing and trading facility for commercial businesses and closed-ended investment companies, with market makers and an order book facility, and transactions have the advantage of full CREST settlement. In March 2005, the Exchange extended the trading facilities to open-ended investment companies. Shares that are partly paid shares may also be traded, which it is believed will be of particular interest to the private equity sector.

Long before the recent boom that has made private equity investment known around the world, the Channel Islands Stock Exchange has been a pioneer in the field as one of the first stock exchanges in Europe to allow the listing of interests in limited partnerships. Today the CISX has a number of these listings, particularly from the Scandinavian region, where this type of structure has been used by pension funds to invest in asset classes such as property and mezzanine financing.



The CISX is widely used for the listing of a range of alternative fund structures, including property and hedge as well as private equity funds. In addition, it has also established a specialisation in truly alternative funds that invest in a broad range of assets, the CISX already lists the first wine fund, two art funds, and forestry and tree funds.

But just as important to the private equity industry is the Exchange's role in providing a tax-efficient means for UK private equity to finance debt. Over the past four years, issuers in England and Wales have been responsible for more than GBP30bn in debt listings on the CISX.

The listing of debt on a recognised stock exchange - as the CISX is by the UK tax authorities - exempts UK issuers from withholding tax on interest payments to investors outside the UK, a provision known as the quoted Eurobond exemption. This is important given the role of debt in private equity acquisition structures and the use of so-called payment in kind notes to pay interest in order to minimise cash payments during the life of the loan. While these payments in kind trigger tax deductions for the issuer, withholding tax becomes payable, hence the importance of the quoted Eurobond exemption to mitigate this tax liability. Since the exemption applied to interest paid as opposed to accrued, it means unpaid interest that accrued before the listing of the debt can escape the tax if it is paid subsequently.

As well as the CISX, various other stock exchanges within the European Union are recognised for the purposes of the exemption. However, because the Channel Islands are not members of the EU, issuers are not subject to a wide range of European legislation including the Prospectus Directive and the Transparency Directive. This means, for example, that there is no requirement to prepare accounts according to International Financial Reporting Standards, with all the additional costs and complexity that entails; the exchange offers issuers the flexibility to use US or UK GAAP instead. This is on top of flexibility in other areas, such as continuing obligations, and the speed and efficiency that gives the exchange an advantage in terms of listing turnaround time.

The CISX has a very international outlook to its business. Nearly 58% of securities admitted to the Official List are structures domiciled outside the Channel Islands, with well over 200 international issuers utilising the CISX for the listing and trading of their securities. Of equal importance is the fact that over 80% of the securities admitted to the Official List are on a primary basis.

Business relationships are all-important to the Exchange and the growing number of international issuers who have made the CISX their exchange of choice may depend on an individual, focused service - an approach that is in keeping with the way business is done in the Channel Islands. The Market Authority understands the need for differentiation and innovation in a competitive marketplace and is well placed to meet the challenges of a demanding and diverse universe of product providers. It is willing to work with each issuer to see how their product structure might fit into the Exchange's Listing Rules and, then, how the Exchange might bring added value to the listing.

The ongoing success of the CISX is directly attributable to its Members, which now total 51. It is the CISX Members who provide the client network, the innovative product structures and first-class services, which in turn attract international businesses to the Islands. The facilities of the CISX are a natural adjunct to the services that its Members provide.

The CISX is cost effective, offering an opportunity for those international businesses already attracted to the Channel Islands to take advantage of a personalised approach and fast track processing of applications within a highly regulated and innovative marketplace.

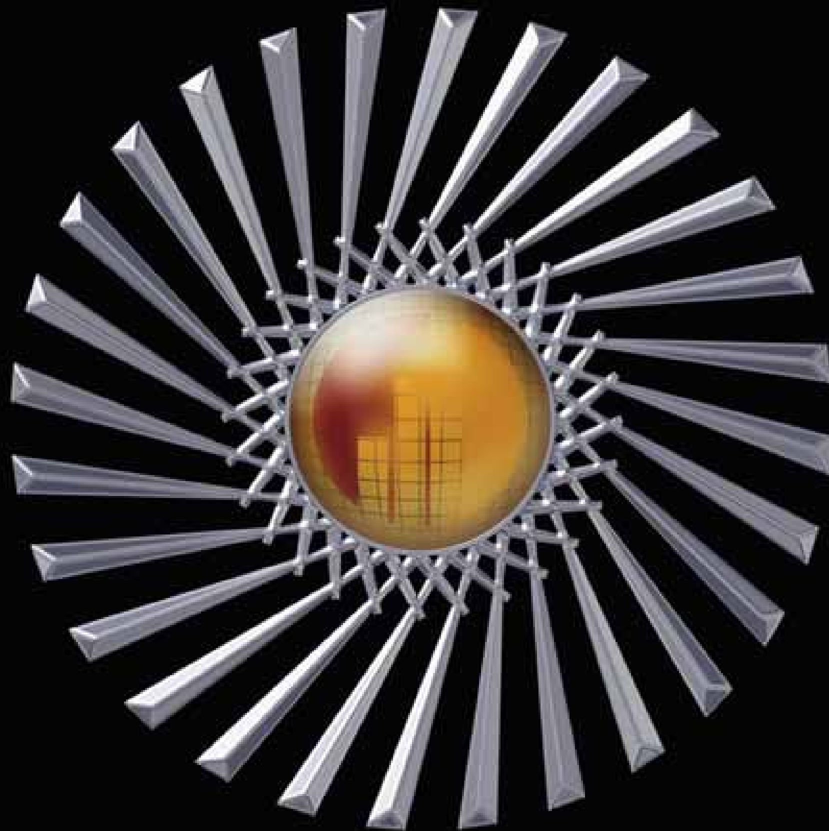
Key strengths

The criteria for selecting which particular finance centre with which to do business are similar to the criteria for choosing on which stock exchange to list securities. Such criteria include high regulatory standards, low costs, professional expertise and efficiency of service.

It is anticipated that the differentiating features of the CISX will encourage new business to the Channel Islands. The key strengths of the Exchange are as follows:

- International standards of issuer regulation
- Timely and personal service
- Competitive pricing
- Enhanced marketability and added value services
- Premier location

The hallmarks of the Channel Islands – high standards and innovation – are reflected in the CISX and its approach to providing a service and structure unique within the European time zone. In looking towards the future, the Market Authority will build on its foundation values with the aim of providing a service second to none. ■



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Telepresence: A Background and Analysis that Goes Beyond the Hype

David Danto is Director of Emerging Technology at the Interactive Multimedia Collaborative Communications Alliance (IMCCA)

Every once in a while a product comes along with both a unique marketing approach and consumer appeal, and thusly redefines the space it is in. Some past examples of this would include "designer jeans" and "gourmet bottled water". In both of those cases the products had been around for many years, somewhat as a niche market, but were branded and promoted to such a degree that they became accepted, if not required, as part of our every day lives. Also in both cases, it was considered blasphemy to point out that the marketing efforts were providing the product with unrealistic or undeserved importance.

So, heathens that we are at the IMCCA, the following article will provide a realistic and balanced overview of the collaborative conferencing industry's shiny new darling, telepresence. It is our hope that this information will help you make the right decisions in your collaboration strategy.

The telepresence prologue

Commercial video conferencing has been around in one form or another since the late 1980s. It is the process of having a real-time conversation with people in one or more locations other than yours – with each location seeing and hearing the other(s). While the technology to enable this has steadily improved over the years, it is still generally perceived as difficult to use and unreliable compared with the traditional telephone - often with a single bad experience leading users to abandon the solution altogether. In reality, today's solutions, if deployed with sufficient planning and resources, can be just as easy as using the telephone.

At a number of times in the history of video conferencing, it dawned on users and/or engineers that one could increase the bandwidth, increase the picture size, and simulate a real meeting between far end participants as if they were in the same room. This more lifelike experience was referred to as "immersive" or "full perspective" conferencing. This model was very expensive to implement, so it was used in a very limited number of applications. For example, companies with two specific offices, that always and only needed to connect two specific rooms using very high quality communication for critical decision making or senior level meetings, found this met their needs very well. There were also a number of innovative business models created utilizing similar systems. One example of these - and one of the true precursors to the telepresence space - was a company named first Teleport, then TeleSuite. Their model aimed to create a hotel network that would avoid the costs and hassles of flying by providing an accessible 'just like being there experience.' (TeleSuite eventually closed, with the technology becoming part of Destiny Conferencing, which was later acquired by Polycom becoming the heart of their RPX system.)

Creating one of these immersive experiences had its difficulties though. The lower quality of codecs of the time and the cost of bandwidth were limitations that were expensive and difficult to overcome. The quality of projected images was also a barrier to the realistic portrayal of the far end. Immersive video conferencing was therefore relegated to the few users that had access to the expertise required to create such customized facilities, had plenty of funding available, and had a true need for these peer-to-peer high quality meetings.

The first real attempt to make this mode of conferencing widely available to business goes back to 2001 and the Global Table product envisioned by a firm called Teliris. Their UK based team created a design to address all of the perceived flaws in the video conferencing offerings of the day. It involved a number of nuances that set them apart. They utilized the newly available high quality displays to improve the appearance of the images. They utilized commercial codecs not being widely marketed to end users. They developed camera positions that optimized eye lines. Then, to address the reliability issues, they provisioned their own network that could handle the unique needs of video, they created hooks into each piece of equipment used so that faults would be reported immediately, and they put a team in place to constantly monitor these rooms and systems.

The Global Table solution had its fans and customers, but with costs going up to a third of a million dollars per room (plus bandwidth) in an industry where the entry point was still less than a tenth of that, it was a difficult sell.

Cut a couple of years later to California, where Dreamworks CEO Jeffrey Katzenberg was very happy to have won his Oscar for the movie Shrek, but was exhausted by the travelling it took between Dreamworks campuses in Redwood City and Glendale and associated facilities in the UK. In order to produce the number of animated films he wanted in the time available, the wasted effort travelling would have to be addressed. High quality video and animations would need to be shared between offices in a collaborative, real time environment. Rejecting the video conferencing solutions available,

Dreamworks and Hewlett Packard created a custom product (soon to be called Halo) to meet this need. Teams in different locations could sit around what seemed to be the same table and share content and conversations. Armed with the newly developed system, HP began to leverage their investment by offering Halo to its customers.

Sometime shortly thereafter, engineers at Cisco Systems (who admittedly hated the video conferencing systems of the day as a prerequisite to join the team) began to design their own system. They developed something they felt would be more of an experience than a product, utilizing high definition images, low latency - high frame rate codecs, and a blending of lighting, furniture, colour and ambience. The 2006 launch of their telepresence product was the quintessential defining of this new niche space. Cisco announced telepresence with great fanfare as a never before seen triumph and positioned it as a solution to replace traditional video conferencing, both infuriating and galvanizing an industry at the same time. Their trademark has become synonymous with all of the products in this part of the conferencing industry. Cisco's visionary CEO John Chambers sometimes personally called the senior executives of other firms to extol the virtues of their solution, often offering "no-charge" demo systems to large Cisco customers - helping their sales team obtain a foothold in the now competitive landscape.

A definition of telepresence

So then, one would have to ask, what exactly is telepresence? Being that it is a market niche rapidly evolving, defining it has been a very difficult task. I was amongst a number of professionals that gathered in San Diego last June to attend the very first Telepresence World conference, specifically to answer that question. We didn't succeed. Some said the conference failed in its mission by not clarifying the continuing confusion around the space. Others said the very effort of bringing almost all of the players together in one venue was a tremendous success in and of itself.

What has become clear is that there are two distinct definitions of telepresence forming. They are not necessarily at odds with each other but the second is couched in more specific and familiar terms used in video collaboration today.

Telepresence – definition number one: telepresence represents the use of a number of technologies, aesthetics and acoustics that together allow a person or people in one location to meet and collaborate with a person or people in another location (or locations) where the experience simulates all people being in the same location. Implied in this experience is the understanding that the technologies, aesthetics and acoustics involved in the simulation are, or should be, practically invisible to the users.

Telepresence – definition number two: telepresence is a video conferencing industry buzzword that represents a class of products that purportedly perform much better than the perceived past video conferencing norms. Any one of a number of differentiators (possibly including high definition video, spatial audio, large screen displays, images projected or reflected in front of a camera's eye line and/or other features) can be identified as the reason a product in the first person (your product) is truly telepresence, and the lack of any or all such differentiators can be identified as the reason a product in the third person (their product) is not truly telepresence.

The debate around the two definitions above can be endless. All manufacturers in the space have their own view and will be more than happy to share it with you.

Why telepresence is great

It would be difficult to come up with a more attractive appeal than the one being used by the current telepresence manufacturers. In comparing themselves to traditional video conferencing systems and products, they stress the following three points:

- The system will meet all of your visual conferencing needs with a quality that is almost lifelike, reducing the difficulties and expenses of travelling.
- Unlike past video conferencing products, telepresence systems are reliable – the calls always go through.
- No specific training is required to use the systems. There are little or no control buttons. Just walk into the room and use it.

It is not difficult to understand why such a message is being widely embraced. Who wouldn't want to invest in a technology that is 100% successful, 100% reliable and requires no knowledge to use.

Beyond these messages though, there is a large list of advantages that a telepresence system will provide:

- A meeting's remote participants will typically appear normal size – as if they were in the room with you. This is called framing.
- Visual details will typically be extremely sharp – you will be able to make out subtle changes in facial expression, which is a key part of interpersonal communication.
- Eye contact between local and remote participants is typically excellent – people will generally look like they are looking at whatever they are actually looking at - and this is important when building consensus and trust in a meeting.
- Sounds are typically directional, just as they would be in a face-to-face meeting – things happening to your left sound like they are happening to your left, and you can hear side bar conversations, just like in a same room meeting.
- Visual images and sound will happen in virtually real time – there is no noticeable delay between participants over great distances. People can interrupt and challenge just like physically being there.

- Depending upon the system and/or services you purchase, an operator or concierge may be at your disposal, connecting calls for you as quickly as you feel you need them. As a user it is just like walking into a meeting room and starting the conversation.

Experienced together, the list above tremendously enhances the quality of a meeting with remote participation. Users will experience less "technology fatigue" than they would have in a traditional video conference. Meetings will be more productive, livelier and more interesting than they may have been in the past. When used specifically in its optimal situation, comparing telepresence to a video conference is like comparing a live orchestra to someone playing a harmonica.

Why telepresence isn't really a single universal solution

Most of the conferencing industry has firmly embraced the hype of telepresence. If you are one of the new firms in the space you're quick to announce that your product is the best thing since sliced bread. If you're one of the traditional conferencing manufacturers you're quick to embrace the onrush of new customers for whom you have a suite of solutions that includes telepresence amongst other offerings. If you're one of the industry analysts you're delighted with the excitement in the space you cover. Everybody is happy.

Remember what your parents said about things that sound too good to be true?

Telepresence systems perform well in very specific applications because of some very specific parameters. Veer from these parameters even a little and the experience collapses.

First of all, the manufacturers' positioning that "telepresence is video conferencing that works/is reliable" requires some scrutiny. Why has traditional video conferencing had reliability issues? The most typical reason for video conferencing failures is the lack of a robust network to support the calls. If your network can't support IP calling rates between devices at 384KBps to 768KBps how will it support telepresence calls requiring anywhere from 6MBps to 20MBps? You're either going to need to buy a whole lot of additional network infrastructure or move your telepresence calls to an off-premises (paid) network. These are both models that the telepresence manufacturers suggest. They are also both models that would "fix" most of the problems experienced with traditional video conferencing.

Another reason traditional video conferences have failed is the inherent instability when trying to call infrequently used endpoints. As an example, your New York to London weekly call may usually work, but your annual Fiji to London call does not. Or similarly, your regular internal calls work, but your calls to a new customer or client site do not connect.

Does telepresence fix theses problems? In the first example, telepresence systems are so expensive that you'll never put one in your Fiji office or anyplace where there would be necessary but infrequent usage – the return on investment would never be justified for the limited applications. In the second example, unless a client or customer has bought the exact same product from the exact same provider that you have, it would take a string of minor miracles (involving connectivity, compatibility, bandwidth, etc.) to connect a telepresence system in your firm's offices to one at their site. Put simply, telepresence is like a luxury car where the steering wheel has been removed and you have about five destinations you can select with a single button on the dashboard. It's luxurious, comfortable, and very, very limited.

Beyond the comparison to traditional video conferencing, the basic telepresence concept presents some challenges in and of itself. When you do have two locations that always need to connect just to each other, each with a non-mobile compliment of staff, then telepresence is the clear answer for high quality, effective communications. But, what if you have three locations…or four? Telepresence systems have really struggled with these multipoint scenarios. One solution is called "voice switched" where a complex algorithm figures out who is speaking and makes sure that person is visible on one of the displays at each location. Another solution is "continuous presence" where everyone at each participating site is visible on the displays (in a smaller image) at all times. While both of these solutions allow for multipoint meetings, it really isn't telepresence anymore. In the first scenario you have to sacrifice the eye contact with those that aren't speaking – which frankly is sometime more important that looking at who is speaking. In the second scenario, you've sacrificed life-sized images, directional audio and all of the other things meant to differentiate the experience. In this frequent real world application the whole reason a firm has invested heavily in a telepresence system is gone. Also gone is telepresence favourable contrast with legacy video conference systems which can do the very same job with a rapid return on a much lower investment.

Human behaviour around the everyday use of telepresence systems also needs to be considered when choosing the right application environment. A smaller company with few locations represents an ideal usage. However, in a typical Fortune 500 firm you're likely working in a very large, multiple story building. Experience shows that it is very difficult to get users to leave their floor to access everyday meeting room spaces. Meeting rooms are requested to be no further than down the hall so that required attendance during a busy work day is not too difficult to achieve. If your firm has invested in a telepresence room, will your high level decision makers actually leave their floor (and possibly leave their building to go across a campus) to use it regularly? Is it that much better than the 50" flat screen and video conference system they may already have a few feet away? This could be true for very high level meetings involving critical

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decisions, but probably is not true for everyday meetings where nearby traditional video conferencing would suffice. On this subject, it is also important to keep in mind that if even one scheduled participant in a telepresence meeting chooses to remotely connect from his local room (assuming you are one of the lucky people that bought a telepresence system that is interoperable with traditional systems), you hit the same problem mentioned above, no life-sized images, no directional audio, again it really isn't telepresence anymore.

IMCCA recommendations for evaluating telepresence

As you look at all of the offerings, we recommend you keep the following "top ten items to consider" in mind.

1. Only consider the use of telepresence systems where you will gain from their true strengths. Specifically, where you have at least two locations with relatively non-mobile personnel that frequently need to communicate with each other on a one-to-one basis.
2. Do not purchase telepresence systems because your current, legacy video conferencing systems are underutilized or unreliable. If those are your problems then seek an expert to help address them. Or in other words, if the plumbing in your house is bad there is no need to buy a new, more expensive house to fix it – get a plumber instead.
3. Determine if you want to utilize (and pay for) outside operator or "concierge" services. If so, select a system that has such a service available as an option. If not, or if this is a security concern, avoid those systems where it is a requirement.
4. Do not purchase any manufacturer's system that has features you currently need "on their roadmap." Assume that what they offer today is what you will have to live with for quite some time.
5. If you intend to use the systems in large cities where the cost of real estate is at a premium, look for systems that allow their room to be utilized for more than just telepresence meetings. Be sure you can make use of the room for more than six people and for meetings that do not involve telepresence.
6. Do not make the mistake of looking solely at the start-up costs of telepresence systems. Factor in the cost of support, operator services, required network upgrades, bandwidth, and real estate. Specifically regarding bandwidth, look for systems that will allow you to scale the bandwidth up or down per your individual needs on a day to day basis. Avoid systems that lock you into the maximum requirement at all times.
7. Look for systems that can provide interoperability with both telepresence systems of other manufacturers and traditional video conference systems.
8. Do not believe the manufacturers when they say a feature you would like is not possible because "it would upset the telepresence experience." That is just doublespeak for the fact that they don't offer it. *Of course, only smart people can see the emperor's new clothes…*
9. If you currently use a management system or software program for your existing video conference units or meeting rooms be sure to purchase a telepresence system that works with that system and does not require the installation of a separate one.
10. When evaluating a manufacturer's telepresence offering, be sure to "pull the plug" on the system – simulating a power failure - and timing how long it takes to reboot from scratch. Despite any reliability claims the manufacturers may make, codecs sometimes need to be rebooted – usually when the participants are already in the room for a meeting and are very impatient about the interruption. Full reset times of more than 1 to 1.5 minutes are inappropriate for the mission critical uses that telepresence is meant to support.

Who are the manufacturers in the space

If you do have an application that will benefit from the unique strong points of a telepresence system, you should do your homework instead of selecting the first system you see or the first system marketed to you. Each manufacturer has strengths and weaknesses that could be very meaningful for your usage. Below is a list of the manufacturers in the space and very brief comments on each of their systems. Please do not use this list as a replacement for going to look at the systems in person and allowing the manufacturers to present their products in context.

Cisco TelePresence

Pros: Very high quality system; leverages the Cisco telephone to launch calls.

Cons: While admittedly rejecting all that was bad about legacy video conference systems their engineers also rejected all that was good – reinventing the wheel awkwardly in many places; a bandwidth hog without scalability; not interoperable with legacy video systems, legacy management systems or even Cisco's own desktop video solution.

HP Halo

Pros: Elegant full-room solution; excellent aesthetics and ease of use.

Cons: Requires connection on HP's private, very expensive network to function.

Polycom RPX (TPX)

Pros: Comprehensive, very immersive full-room solution; innovative use of hidden cameras and displays for data collaboration; can scale from 4 users to 48 users; fully interoperable with all legacy video conference systems; VNOC (concierge) services available as an option but not required.

Cons: RPX utilizes older model projection that could use some updating. Their new product (TPX) - offered side by side with RPX as a lower cost choice - undermines their arguments for using RPX.

Tandberg Experia

Pros: Least expensive appliance based telepresence system available; assembled from their very reliable MXP series codecs and cameras.

Cons: Minimalist approach requires you to come-up with room aesthetics on your own – essentially telepresence on a cart.

Telanetix Meeting Room Edition

Pros: Lowest cost telepresence system available.

Cons: Utilizes software based codecs – not as robust as appliances.

Telepresence Technology TPT42 & custom solutions

Pros: Produces remarkable 3D images of remote participant(s); maintains perfect eye line by viewing images reflected in front of the camera lens.

Cons: Not a complete solution – utilizes other's codecs; does not scale well for multiple far-end participants in a single room.

Teliris VirtuaLive

Pros: Has been serving the market longer than other large manufacturer and has developed remarkable camera tracking technology to assist in very lifelike conferences.

Cons: Will not sell you their technology – you have to pay an ongoing fee to use it, and you are forced to use their monitoring services.

Summary

Once one takes an objective look at all of the nuances of the systems available, and all of the potential applications, it becomes clear that telepresence is not a replacement for traditional video conferencing. It is a valuable application as part of a broader video collaboration strategy that includes traditional video conferencing. In fact, it could be argued that telepresence is just another form of video conferencing, albeit at a high level. It is clear that organizations that want to maximize their competitiveness and their capital ROI should utilize telepresence only where it is the correct choice, and implement a complimentary, interoperable, reliable video conferencing solution along side it for maximum benefit.

It is also clear though that the world of collaborative conferencing has forever been changed by the emergence of modern, widely available telepresence systems. These systems do have the potential of providing dramatic results in both performance and travel cost/hassle avoidance. Hopefully, as people get past the hype about them, telepresence systems will stop being the industry's "shiny new darling" and will take an appropriate place in the catalogue of solutions available to assist and support business communications for many years to come.

About the author

David Danto has spent thirty years in the audio visual and broadcasting industries. He has designed facilities for firms such as AT&T, Bloomberg LP, FNN, Morgan Stanley and NYU. He is a contributor to many industry publications and a sought-after presenter at industry conferences and events. He is currently the Director of Global Multimedia Engineering for Lehman Brothers and an Executive Board member of the IMCCA. David can be reached at IMCCA@danto.com. Also contributing to this article were IMCCA Board Members: S Ann Earon, Chairperson emeritus, Phil Keenan, Chairperson and Carol Zelkin, IMCCA Executive Director.

About the IMCCA

The IMCCA is a non-profit industry association resolved to strengthen and grow the overall conferencing and collaboration market by providing impartial information and education about people-to-people communication and collaboration technology and applications. Founded in 1998, the IMCCA membership is open to end users, vendors and other interested professionals who wish to share their disciplines and knowledge for the benefit of members and the interested general public. The IMCCA offers an open and interactive environment for these activities, including participation in trade shows and industry events and the IMCCA Website. If you are interested in more information about the IMCCA please visit our website www.imcca.org or contact the Executive Director, Carol Zelkin at +1 516 818 8184 or czelkin@imcca.org

The IMCCA will be presenting and sponsoring the following events on telepresence:

1. Integrated Systems Europe- January 29th-31st at the Rai Convention Center, Amsterdam, Netherlands. www.iseurope.org
2. TELEPRESENCE World- March 18th and 19th at the ExCel London Exhibition and Conference Centre. www.telepresesenceworld.com ■

Slovenia holds the Presidency of the European Union until June 2008, is in negotiations to join the OECD, and is a driving force behind the enlargement of the European Union. Tom Page interviewed Dimitrij Rupel, Foreign Minister, and Dr Žiga Turk, the Minister for Growth, Republic of Slovenia.

The Union is showing signs of 'enlargement fatigue'. Many politicians worry that an ever larger Union will function badly, and that further widening will come at the expense of deepening. West European workers fear the economic consequences of adding 50 million low-cost workers to the EU single market. Future accession would be very difficult unless public and political support for enlargement revives. Croatia's membership bid encounters little opposition, and the EU has accepted the other countries of the Western Balkans as potential candidates. Turkish accession negotiations, however, remain controversial. And the EU has not offered the prospect of membership to former Soviet countries such as Ukraine and Georgia. How can the EU address these concerns?

Dimitrij Rupel: Slovenia sees the enlargement process as a historic opportunity to promote and ensure peace, stability and prosperity in Europe. Furthermore, the enlargement process helps the transformation of the countries involved, extends democracy, human rights and the rule of law throughout Europe. The carefully managed enlargement process is one of the EU's most powerful and efficient policy tools. Slovenia believes that the enlargement doors need to remain open to any European country that is able to meet the political and economic criteria and fulfill the obligations from the membership. In our view, the EU perspective for aspirant countries will continue to accelerate reform and promote greater stability in the region and in the Europe as a whole.

Firstly, even before the debate over the EU constitution, many experts believed that enlargement was reaching its limits. Enlargement fatigue in the wake of the addition of 12 new members and the rejection of the constitution by France and the Netherlands, due in part to concerns over the impact of enlargement, has become a serious issue in Europe. However, the new reform treaty aims at making the enlarged EU work better and more efficiently. Surely, if we had no new treaty, we would not be able to cope with further enlargement. Therefore, this agreement represents additional achievement.

Secondly, membership perspective works as an extremely powerful incentive for reforms. Looking at Croatia and Turkey in the last couple of years and what the prospect of accession did to enhance human rights as well as political and economic reforms. Nevertheless, their progress towards the EU depends on how and when the countries will deliver their commitments. In this context and in the wake of the violent conflicts that marked the recent history of the Western Balkans, Slovenia considers enlargement as a priority, which promotes the development of peace, stability and freedom in the region. The framework for this approach in the Western Balkans is the Stabilization and Association Process, which is designed to encourage and support domestic reform processes. In the long run, the process offers the prospect of full integration into the EU structures and policies, provided that certain political and economic conditions are previously met. The so called Stabilization and Association Agreements are therefore the first step on the road to the future EU memberships and the gateway to candidate status. For the time being it would be irresponsible to disrupt this valuable process that is helping to build stable and effective future partners in the unstable part of Europe. If the EU is indecisive about the Western Balkans long-term prospect of the EU membership, its beneficial influence will be seriously eroded just when the region is entering one of the most difficult periods of resolving Kosovo's final status.

The EU has already promised the countries of the Western Balkans and Turkey the EU prospective once they will meet the anticipated conditions. We believe that EU member states will conduct a constructive debate in accordance with the enlargement strategy and main challenges 2006-2007, confirmed in the GAERC and European Council conclusions of December 2006, which reaffirmed the EU commitments and its credibility. Otherwise it would weaken the EU ability to help to those countries in their work toward stability and democracy in the region and thus harm Europe's own interests. It this context it would be wiser to export stability to the Western Balkans through the enlargement process than to import instability in the shape of refugees and criminal activities in the EU.

Later but not the last, for any of its policies, including enlargement, the EU has to win the support of its citizens. Better communication is an essential part of the EU enlargement policy in maintaining confidence about the EU integration capacity. Citizens need to be better informed about the future enlargement process of the EU. We need to communicate better the advantages and the challenges of further enlargement. By we, I mean the Union, the Member States and candidate countries and our European and national parliaments need to intensify our efforts to foster mutual knowledge, understanding and development of the ownership of this common European project.

As for the prospect of the membership of the former Soviet counties, the EU is addressing the issue through the European Neighbourhood Policy with the objective of avoiding the emergence of new dividing lines between the EU and its neighbours. However, the European Neighbourhood Policy remains distinct from the process of enlargement although it does not prejudge how the relationship between respective countries and the EU may develop in future.

Education is the key for achieving many of the goals that the EU has set itself in the Lisbon agenda, such as higher growth, and more innovation and Entrepreneurial activity. Since well-educated people are more likely to have a job, education reform is also crucial for raising Europe's employment rate. Skill levels are improving, but the overall picture is mixed. What are your views on this core issue?

Dr Žiga Turk: In the triangle of innovation, research and education, it is obvious that in Europe education is the weak part. The reform of education systems need to be conducted on the local basis in each country, focusing more on fostering creativity, individual work, project based work, discovery, experimentation etc. Creative, risk taking and courageous kids that are encouraged to think out side of the box are more likely to grow into successful entrepreneurs.

New ideas and innovations will help create new jobs, will help in finding new methods of protecting our environment, ensuring safer food and medicines, safer and sustainable energy resources etc. The development of modern research in a global context makes it necessary to co-ordinate and complement efforts made at national level in the member states. What are the challenges for science and technology in Europe, and what is your vision for the future of science and technology in Europe?

ZT: It is important to create synergies between R&D, innovation and enterprising, for example in the area of environmental technologies. In the ICT revolution Europe plays a marginal role. In pharmaceuticals and biotech the EU has lost the ownership of important business players.

Europe, the west as a whole, is loosing the monopoly in science and technology that it held in the last 500 years. But a lot of world class research is at home in Europe and it needs to be cherished. But we must get better at spinning its results off to new products and services. We should be better in concentrating the resources, creating the critical mass, not by physical concentration but by creating the proper networking structures. The JTIs are a step in the right direction, the tightening of the ERA and the involvement of the other ERA, European Researchers Abroad, into the European knowledge space. The synergies between national and European research projects need to be strengthened, because the EU us sponsoring just about 5%, not more.

European R&D projects, such as the Framework programs, could benefit if they could rely on an internal, independent think tank to define policies and evaluate proposals. There is a need for more

transparency in the evaluation process and much less red-tape in the management of the projects. The results of the government sponsored research should be openly available.

I would like to add, that science and technology alone are not enough to push the EU forward. Creativity is just as important as innovation. Europe has a strong tradition in culture, in creative industries, in design, media, architecture... The creativity of the European talents is just as important as innovation for the future prosperity of Europe. Creativity in sense of thinking out of the box, doing bold new things differently, breathing the meaning and values into products, based on our cultural and ethical background.

I would like to see the updated Lisbon strategy also to address these softer issues, I would like it to be brought closer to the people and entrepreneurs, because there, and not in rigid government institutions, is the greatest potential to make Europe a more dynamic economy, perfectly fit to the challenge of the Asian economies.

And finally, what would be your message to companies considering Slovenia as a strategic location within the single market?

ZT: Slovenia is excellently positioned on the gateway between central Europe and the Balkans and has excellent understanding of the region. It is in the middle of the 5th corridor between Barcelona and Kiev and has an ambition to make it more than just a transport line. It should become an axis of growth, and of high tech and creative industries. Slovenia can offer a good business environment, ICT infrastructure, transportation connections, also educated, hard working people and professional, streamlined public administration.

It is a good place to live as well. The best proof is perhaps that very few Slovenes are migrating to other EU countries. Here we enjoy a very good quality of life, good wines, human-sized cities, charming old districts crowded with young people and beautiful outdoors minutes from downtown, offering ample sports and recreation opportunities. ■

Jet Centre Flies Higher

If you're reading this, chances are you've probably already flown in and out of London via the Jet Centre at London City Airport. The tidy position and proximity to London's hotspots of the Jet Centre is ideal for those flying into the city. The Jet Centre opened five years ago and has already seen a dramatic increase in jets flying in and out of the airport. Indeed with a 450 per cent increase of jet movements in five years alone it is safe to say that private air travel is becoming a more commonplace method of transport for time-pressed executives.

It is also interesting to witness an increase in leisure traffic at the weekends. Currently 20 per cent of all outbound flights from the Jet Centre on a Thursday are heading for leisure-bound destinations. It is evident that time is the ultimate luxury and now busy professionals are whisking their families off by private jet in order to utilise every precious minute of a short weekend without having to endure the hassle of busy terminals and lengthening delays that are often suffered by passengers of schedule flights.

In September 2002 the Jet Centre recorded approximately 250 aircraft movements compared to the same month in 2006 when over 1,300 aircraft movements took place, this figure, representing over ten per cent of movements for the entire year. This increase in traffic has inevitably led to the management seeking further opportunities outside of East London. Following the tremendous growth at London City Airport's Dockland's-based Jet Centre, in July 2006 the Jet Centre took over passenger handling of private aircraft flying in and out of RAF Northolt. Primarily a military airfield, RAF Northolt benefits from its close proximity to West London and provides passengers with the option of using an airport west of the City. Northolt also offers passenger the opportunity of using aircraft that could not handle the steep approach required at London City airport, such as the Gulfstream, and provides the customer with a choice of long-range aircraft from London.

With increasing demand the Jet Centre is now faced with an enviable dilemma of being too popular for its own good. London City Airport has commenced construction of new stands over the dock that, when complete in the summer of 2008, will offer a considerable increase in capacity for aircraft. Additionally, Darren Grover, Head of Aviation at the Jet Centre, is now tasked with seeking out suitable existing sites in order to grow the Jet Centre operation further. "We are very committed to corporate aviation and this is demonstrated in the $39 million London City Airport has invested so far. We're in it for the long term and the surface has not yet been scratched in Europe. We foresee enormous growth in the mid to long term," said Grover.

To satisfy growing demand from time-pressed executives that do not have access to company-owned aircraft, London City Airport created PrivateJet, an additional service from the Jet Centre that arranges private aircraft charter for leisure and business. PrivateJet has access to thousands of high quality aircraft across the world, whether for simply going to the races or a corporate jet capable of transcontinental missions. The cost benefits of chartering aircraft through PrivateJet are considerable for those organisations that do not want to take on the purchase and maintenance cost of aircraft as flying time is charged by the hour, with a dedicated account manager arranging everything from slots bookings to fresh flowers on board the aircraft.

Companies using in excess of 350 hours per year should consider purchasing their own dedicated aircraft. PrivateJet is able to provide guidance throughout the entire process of owning an aircraft, from purchase through to delivery, crew selection and insurance. Through PrivateJet's group buying scheme, companies can benefit from generous discounts on fuel and handling rates. Private jet ownership also offers tax benefits. The amount of depreciation can be deducted from the company's taxes each year. The depreciation value in the first five years of ownership can be anything up to 30 per cent per year, making jet ownership a handsome option.

Recently voted Best Airport at the NetJets Europe Excellence Awards, Grover confirms that the Jet Centre and PrivateJet are committed to the needs of its customers and passengers: "We are constantly monitoring our business to ensure we are delivering what our customers want - it is our number one priority".

With this level of commitment from the UK's most successful corporate aviation centre, it's clear to see that the future of private jet travel is in very safe hands. ■

Business Aviation: A Vital Tool in Today's Economic Marketplace

Dan Hubbard is Vice President of Communications at the National Business Aviation Association

Increasingly, business aviation has come to be recognized as a necessary tool for conducting business in today's busy marketplace.

While companies that rely on business aviation represent many different professions and locations, they all have one thing common: they need fast, flexible, safe, secure and cost-effective access to destinations across countries and around the world. In many instances, business aviation is the appropriate transportation solution, opening the door to global commerce for small-community and rural populations by linking them directly to population centres and manufacturing facilities.

Therefore, companies large and small are becoming ever more adept at utilizing aircraft for key employees to reach new markets for products and services, to sell and deliver, to provide customer service, to extend management control and to improve investor relations.

In the US, business aviation has become an essential operating tool for businesses of every size. About 85 percent of the US companies that utilize general aviation aircraft for business reasons are small and mid-sized businesses located in every state in the country.

The economic contributions of business aviation are undeniable. In the United States, a 2005 study commissioned by the General Manufacturers Association and the National Association of State Aviation Officials concludes that general aviation, of which business aviation is a part, contributed more than $150 billion to US economic output, and directly or indirectly employed more than 1,265,000 people whose collective earnings exceeded $53 billion.

And the value of business aviation is increasingly understood beyond US borders. Flight planning services have seen international activity up about 30 percent in recent years, with the majority of flights going to Europe, Russia, Asia-Pacific, Latin America, the Middle East and Africa. Major engine manufacturers forecast that, in the coming years, markets outside the US will make up about half of all aircraft sales.

These trends explain the need for events that bring together business leaders, government officials, manufacturers, aviation department personnel, single-pilot operations and all manner of people involved in nearly every aspect of business aviation. Providing such industry-leading events for the business aviation community has for decades been central to NBAA's mission, and the Association built upon the tradition in 2007.

NBAA Annual Meeting & Convention

Ranked among the top 10 trade shows in the US by Tradeshow Week 200 magazine, the 60th Annual Meeting and Convention, held in September 2007, served as the industry's premier event and annual meeting place for the business aviation community.

The 2007 event, held at the Georgia World Congress Center in Atlanta, Georgia, marked not only the 60th anniversary, but several important milestones for the industry.

The show was an enormous success, featuring more than 1,000 exhibitors displaying products and services at the Georgia World Congress Center, with a sold-out Static Display of Aircraft on view at nearby Fulton County Airport.

The remarkable event was attended by more than 32,000 people, who also had access to discussions by top experts from government and industry, focusing on the influences and trends impacting business aviation.

Among the highlights were:

- A Media Kickoff Breakfast featuring top leaders with the NBAA and the General Aviation Manufacturers Association (GAMA) and focusing on the challenges and opportunities facing the general aviation community.
- A panel discussion on business aviation security protocols and considerations featuring guests from the Department of Homeland Security, private-sector security consultants and former members of the National Transportation Safety Board. The panellists examined how the aviation environment has changed since 9/11, both in terms of regulatory changes and the increased responsibility of flight departments for security.
- A "Meet the Regulators" information session including three top officials from the Federal Aviation Administration, who examined the safety record for business aviation, including an exploration of the need for safety management systems (SMS).

ABACE

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STATIC DISPLAY ...
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- A panel about the emergence of Very Light Jets (VLJs) – those weighing less than 10,000 pounds, priced below the average cost for jet aircraft, and capable of being flown by a single pilot – and the unique safety and other operational considerations for these types of aircraft.
- A discussion focusing on enhanced vision systems (EVS) and synthetic vision systems (SVS) – technologies to revolutionize aircraft cockpit visibility – featuring representatives from the National Aeronautics and Space Administration (NASA) and Federal Aviation Administration (FAA).
- An information session about the influences driving the evolution of aircrew training, including increased use of advanced technologies in both aircraft and training equipment, the need to lower training costs and reduce training time, and the desire to tailor training more to specific operating environments (airports, weather conditions, etc.).
- A discussion of the "user fee" threat facing the industry in the US, and the airlines' ongoing attempt to shift billions of their costs onto general aviation, introduce new user fees and assume control of the air traffic control system.

NBAA plans to build on the success of the Association's 60th Annual Meeting & Convention and other 2007 events in 2008, starting with the ABACE Forum 2008 (ABACE2008), taking place on February 14, 2008.

ABACE Forum 2008

The timing for a business aviation event in Asia couldn't be more appropriate. The potential for business aviation in Asia is enormous. The population, economic activity, and need for transportation to cover the distances between business locations – in some cases where no practical transportation alternative exists – is immense. But, the Asian business aviation market is emergent and at the beginning of its evolution.

The ABACE Forum 2008 will be the only major Asian event focused solely on business aviation, a premier meeting place for the industry in Asia. New business aircraft firms, avionics firms, handling organizations, fractional providers, charter/lease companies and previously titled aircraft resellers will display their wares.

With its slogan, "Good Things Await Business Aviation In Asia," this event will help to catalyze the Asian business aviation market, educate regulatory authorities in the region and expose Asian business leaders to the benefits of business aviation, so successful in other parts of the world.

Scheduled for February 14, 2008, at the Hong Kong Business Aviation centre at Hong Kong Airport, the ABACE Forum 2008 will showcase over 50 Exhibitors displaying the latest airplanes, helicopters, aviation equipment and services, and – as with other NBAA events – this one will provide information about the latest developments of significance to the industry.

The ABACE Forum 2008 will kick off with an Opening General Session with an event featuring NBAA President and CEO Ed Bolen, Asian Business Aviation Association President Jason Liao, and other noteworthy figures who will discuss the potential for business aviation in the Asian region. Afterward, the exhibit and static display of aircraft will open, and the event will get underway, bringing value to all who attend.

Recognized authorities from government and industry will discuss issues specific to the Asian region, as well as topics that have global application to business aviation, and information about international efforts to support the industry in Asia and around the world.

How do I attend or exhibit at the ABACE Forum 2008?

Those wishing to attend or exhibit at the ABACE Forum 2008 should use the following contact information:

ABACE Forum 2008 USA Office
Attn: Ms. Donna Raphael
1200 Eighteenth St. NW, Suite 400
Washington, DC 20036-2527 USA
Tel: (202) 783-9000
Fax: (202) 862-5552
E-mail: info@abace.aero

About the organizer

Founded in 1947 and based in Washington, DC, the National Business Aviation Association, Inc. (NBAA) is the leading organization for companies that rely on general aviation aircraft to help make their businesses more efficient, productive and successful. The Association represents more than 8,000 companies and provides more than 100 products and services to the business aviation community. Learn more about NBAA at www.nbaa.org. ■

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Beware the Peril Knocking At the Door

David Savile is Chief Executive of Air Partner plc, one of the world's largest and most respected private aviation companies

Time has run out for companies who have failed to consider their duty of care towards employees.

The UK's much-vaunted Corporate Manslaughter and Corporate Homicide Act becomes law on April 6. Under the new legislation, organisations should expect to be found guilty of the new offence if the way in which its activities are managed or organised causes a death.

It is surely imperative that companies think again about managing, rather than averting, risk and have contingency plans in place that demonstrate proactive due diligence towards their personnel.

A decade after globalisation began in earnest, thousands of companies employ millions of expatriates in overseas territories, with growing numbers located in countries with increasing political, hostile and natural risks. Consequently, their duty of care towards expatriate workforces has become an ever-more serious and intense issue.

Directors on multi-national main boards need to consider three aspects of duty of care protection: security on the ground, access to immediate medical assistance, and concrete plans for country evacuation if essential.

My experience with hundreds of companies has demonstrated that the first two aspects are covered with great competence because, by their very nature, these services can be needed on a daily basis; the third is often ignored or ill-considered. Many assume that ready solutions will be waiting for their staff at the nearest international airport and that a handy collection of open airline tickets will solve most problems. Not only is this incredibly naïve, it is also irresponsible. If severe trouble were ever to strike a popular Gulf trading city and 50,000 or more expatriates wanted to exit at the same time, this would require some 150 wide body jets. Where do you think they are going to come from and would you be confident your staff would be on them?

The new UK Act sets out a new offence for convicting an organisation where a gross failure in the way activities are managed or organised results in a person's death, amounting to a gross breach of duty of care.

Where proactive work has been done it usually lacks detail, contains flaws or fails to recognise some basic false assumptions. International airports, for example, are often the target for insurrection and attack; and local airlines are quick to extract their assets at the first sign of trouble, usually well in advance of hopeful evacuees flocking to the departure terminals amidst the instability.

What makes some companies think that their key staff are going to fare well, thrown into such an environment?

Evacuations require speed, discretion, political correctness and, more than anything else, a detailed series of clear plans (designed in peacetime) that can be followed according to the perceived direction of the threat.

Back in 2000, the global private aviation company Air Partner established first-mover advantage in mass-evacuation strategies when it launched its Emergency Planning division; this provides the only integrated corporate emergency pre-planned aviation evacuation service available worldwide. Seven years later its experience is unique, unparalleled and there remains no credible air service rival. As the aviation specialist with almost 50 years' experience, its 250-strong team of aviation professionals in 23 global offices provide every type of aircraft, for every conceivable mission, on every part of the planet.

Industry, commerce, governments, the military, humanitarian organisations, individuals… all rely on Air Partner-organised emergency airlifts for expatriates from some of the most extreme locations, often operating in hostile environments alongside the military. Over the past decade the Group has launched more than a quarter of a million flights, spent over £1 billion and delivered success in the air to over 5,000 clients. Its record stands alone.

With the civilian airline industry seemingly in an endless boom period, it is easy to think that any number of carriers could be called upon at a moment's notice to assist with an evacuation. The reverse is the case. Since 9/11 the airline industry has been turned on its head; in just one year 200,000 airline jobs disappeared, many from middle logistics roles. Today all carriers are 'low cost' in structure and manpower, even if they face the customer as 'full service' airlines. The result is that very few have logistics teams poised to mount a rescue, and sending a $50m-$100m asset into a hostile and largely unknown environment at short notice is the last thing they want to do. Consider the proposition to the airline: financial gain is negligible, operational problems are extreme, the risk to planned flight programmes is high and the workload to mount a mission almost impossible from in-house resources. Add to that the need for a volunteer crew and war risk cover on the hull, plus the corporate politics of the airline brand potentially appearing in tomorrow's TV news headlines. Not surprisingly, you'd be lucky if one in a hundred airlines expressed a willingness to help even a major multi-national.

Hence the need for a specialist. Air Partner approaches the problem from a very different position; the talent needed is in-house, provided by a team of experienced brokers who know which carriers and operational managers are up for the challenge. Additionally, the company's ownership of the global air logistics operation, Air Planner, means it is capable of providing immediate flight planning services,

arranging route planning, diplomatic and overflight clearances, landing permissions, fuel supply, slot co-ordination and the like, anywhere in the world, using the same live software used by major airlines.

Not surprisingly this talent is much in demand. Used by more than twenty governments around the world, Air Partner is always at the centre of air operations when crises happen. Lebanon in 2005 was one prime example, when it evacuated 7,500 people in a matter of hours over one weekend. The operation was 100 per cent successful and is claimed as the largest civilian evacuation since Vietnam. Since then the company has been repeatedly tested and proved able to handle whatever is thrown at it.

However, the service is not successful by chance, and the company does not offer an ad hoc "let's have a go… tonight" service. Its secret is one of detailed advanced planning, ideally months in advance, so every permutation is covered before a crisis arises. Success is judged by the ability to react and evacuate before the crisis has gained its hold on critical infrastructural assets (roads, airports, bridges, ports and seaways).

Air Partner's ability to move large numbers of people quickly to locations that would otherwise be unreachable sets it apart from other forms of evacuation. When panic, fear, frustration, delay and chaos take a grip, dedicated aircraft offer customised schedules on private jets or airliners from anywhere, to anywhere, and with the client in complete control over those on board.

Air Partner has been organising evacuation flights since Gulf War 1 and since then has pulled tens of thousands of people to safe havens from places such as Iraq, Iran, West Africa, Afghanistan, Chechnya, Indonesia, East Timor and the Ivory Coast. It puts critical emphasis on helping companies protect their key workers in volatile and remote regions where facilities and procedures can often be unfamiliar and dangerous. Once developed, escape plans are continuously updated and meticulously maintained, poised for implementation at a moment's notice.

None of this would be possible, however, without a team of the highest calibre. As should be expected, experienced, dedicated and professional aviation experts are on 'red alert' 24 hours a day, 365 days a year, currently overseeing country-specific air evacuation planning and implementation services for 100,000 key workers in over 50 countries.

Leadership of the global Emergency Planning team is the responsibility of Jerry Parr, a former Wing Commander with the Royal Air Force. On his last tour in the RAF, Jerry worked for the Ministry of Defence Central Staff with particular responsibility for UK military activities in the Far East. Having taken early retirement from the RAF he took up a newly formed appointment in the Royal Travel Office at Buckingham Palace where for two years he was responsible for the organisation and management of all the air travel requirements for the British Royal Household. Jerry joined Air Partner in 1999 and now spends much of his time travelling to some of the most dangerous and vulnerable corners of the globe gathering first-hand information for the comprehensive implementation of evacuation strategies.

The North America-based Emergency Planning team is led by Susan Hazard, who has more than 20 years' experience of aviation and travel at the highest level. Notably, she was director of the White House Travel Office from 1995 to 2001 and a Special Assistant to President Bill Clinton, managing the multi-million dollar White House Press Corps charter travel and logistics programme. Prior to that, she established Travel Incorporated, a Washington DC corporate and political travel agency.

In the end, the responsibility for maintaining employee safety while on foreign soil and making sure they have a viable escape route in times of danger rests firmly on the shoulders of corporate directors. Air Partner evacuation plans not only take into account why an evacuation should take place, they are also balanced to provide an appropriate response to any perceived danger. For example, if one company starts to evacuate and the herd instinct takes over, this can raise significant legal issues; if personnel from companies that remain in-country get injured or die, claims of negligence and corporate culpability are inevitable, the defence of which will be far more costly than the evacuation.

Planning strategy should take into account the fact that few companies would want to evacuate all of their staff from a country at the first threat because this makes returning vastly more difficult. A common scenario allows for smaller teams to remain on-site longer while still offering a sensible exit solution if the tension boils over. The planning should look into every possible detail including identification of weather patterns at likely evacuation airports or airstrips, bearing in mind that local seasonal conditions could make a huge difference to the effective extraction of employees, as well as the nationalities of all offshore corporate staff to avoid diplomatic no-go's.

Preparation is the greatest tool for risk management. Once risks have been assessed, an evacuation plan is in place and strategic partnerships have been formed with reliable emergency service providers, details must be communicated and practised. As a continuously evolving document, a plan needs to be updated regularly. With routine training, personnel who have been reassured that their well-being is important to their employer will develop an automatic crisis response, thus making an evacuation more efficient and manageable.

Managing the growing challenges of an unstable global environment and assessing potential threats to a business is a challenging but crucial task. Companies who skim over the issue of pre-planned evacuation strategies do so at their peril.

One thing is certain, employee safety, business security and global brand protection should never be left to chance. ■

Business Jet Travel Rides Wave of Success in Europe

It's the ultimate fantasy for the business traveler – hassle free travel. Imagine parking your car a short distance from the runway, breezing through security, having business facilities to continue working onboard and arriving at your destination in the same amount of time it takes some commercial travelers just to check in. After completing a full working day your aircraft is waiting to bring you home in time to kiss your kids goodnight- while on a commercial airline you would be flying out the next day.

It's no surprise demand that private jet travel is at a record high. These days more and more businesses are employing the services of NetJets, the largest private jet company in Europe to increase executive productivity, efficiency and ensure stress levels remain low.

Executives are packing away the days of rescheduling meetings around airline delays and waiting in long queues or at baggage claim; with NetJets Europe all you have to do is arrive at an airport conveniently located to you, at a time of your choosing, and comfortably travel to where you want to go.

Companies no longer regard private jet travel as an extravagant luxury and, as a result, industry growth has moved into unparalleled territory: with NetJets Europe as the clear market leader.

NetJets Europe has over 1500 of the world's leading decision makers and opinion leaders as its clients. Five years ago, the company had only 18 aircraft and 89 customers and today it boasts 135 aircraft. According to Mark Booth, Chairman and CEO of NetJets Europe "We are growing faster than anybody else."

This year has been hugely successful for NetJets Europe. Flight activity across Europe is up over 20% year on year, and 2007 has already seen the company fly to 866 airports in Europe and 126 countries. The UK in particular has experienced considerable growth. As a result of this massive increase in demand for it's product, NetJets Europe placed the largest business jet order in history late last year - a $1.1 billion order for 24 state-of-the-art Dassault Falcon 7X aircraft. A few months ago the company added nine more 7X to the order making the order's value greater than $1.5 billion. This year, NetJets will have taken delivery of twenty-four new aircraft valued at $380 million – increasing the size of its fleet to 138 aircraft.

Mark Booth, attributes the growth to the flexibility and convenience of the service, stating, "We are living in an increasingly on-demand world. I want to conduct business on my own schedule, so when traveling is part of that business, why should I do it on someone else's? At first it seems what we're selling people is luxury, but what we're really selling them is time and in any business, time is money."

The man behind the phenomenon, Richard Santulli, a former Goldman Sachs banker and the founder of NetJets, contemplated the economics of private jet travel back in 1986. He founded NetJets on the notion of fractional ownership, realising many people needed the use of a private jet, but didn't need it everyday. Santulli explains: "I realised that if I could come up with a programme where the economics were the same – sharing the cost – all I had to do was guarantee the service, then I would have something that would be very, very successful."

With NetJets you can buy your own $4 million private jet for 1/16th of the price. NetJets Europe offers individuals and companies the opportunity to buy as much, or as little, of an aircraft as they like without the responsibility of its upkeep. Customers can buy a share of an aircraft equal to the amount of flying hours they need, for an 16th of an aircraft a customer is entitled to 50 hours of flying time per year. For those customers who fly less than 50 hours a year, NetJets Europe offers the Card Programme where customers have all the benefits of private aviation with minimal cost and effectively pay for 25 hours in the sky.

NetJets Europe's offers a solution to suit everyone and the increase in NetJets' corporate clients is staggering. It seems that when you get used to traveling this way for business, it might be a difficult habit to kick. During the Rugby World Cup in Paris this year, NetJets Europe's flight bookings exceeded one hundred with England fans desperate to get to the Stade de France for the final. With commercial flights fully booked well in advance, NetJets customers had the luxury of booking their flights with as little as ten hours notice and coolly arrive at Paris's Le Bourget airport, located minutes from the stadium, avoiding the congestion of Charles de Gaulle.

As well as convenience, NetJets Europe offers its customers peace of mind. With everyone these days concerned about climate change, NetJets Europe has taken an industry leadership role and earlier this year launched a comprehensive environmental strategy. NetJets has pledged to make the entire company as well as all its customer operations 100 per cent carbon neutral by 2012. This is no mean feat for an aircraft operator and by making it compulsory for all its clients to offset their flights, its efforts run deeper than most airlines who offer opt-in programmes for their customers to offset their flight emissions. The multi facetted strategy also includes investments in innovative new fuel technology and well as energy saving techniques.

NetJets Europe offers all the benefits of safety, speed and flexibility allowing you to go wherever you want when you want. NetJets will make your travel completely hassle free allowing you to take control of your time in the sky. ■

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Joe Clark is the Congress Secretariat

Profile

The Global Congress on Combating Counterfeiting and Piracy represents a unique, international public private sector partnership that is united in its efforts to identify solutions and facilitate their implementation to the growing menace of the illegal trade in counterfeiting and piracy.

The Congress is led by a Steering Group formed after the First Global Congress hosted by the World Customs Organization (WCO) at its headquarters in Brussels in May 2004. The Steering Group is chaired, on a rotating basis, by the WCO, Interpol and the World Intellectual Property Organization. The Congress and its Steering Group are supported by the world's business community which is represented by the International Chamber of Commerce (ICC) through its BASCAP initiative, the Global Business Leaders Alliance Against Counterfeiting (amalgamated with the ICC in January, 2007), the International Trademark Association (INTA) and the International Security Management Association (ISMA).

The Steering Group, based on the input of its member organizations and delegates attending the First Global Congress, determined that its purpose would be to raise awareness of the growing problem of counterfeiting and piracy, share information, develop strategies to combat the illegal trade and identify practical actions and potential solutions. To date, the Steering Group has convened three Global Congresses and four Regional Congresses that have brought together global political and business leaders and experts from law enforcement, the judiciary, academia and the private sector to share strategies, program concepts and identify priorities for action. Recommendations and suggestions have been produced following each of the seven Congresses.

The Global Congress has become the premier international forum for shaping practical strategies to combat counterfeiting and piracy as evidenced by the prestigious speakers and growing numbers of delegates attending each successive Congress. For example, the Third Global Congress, convened in Geneva in January 2007, was attended by over 1,000 people representing 107 countries from around the world.

The Fourth Global Congress on Combating Counterfeiting and Piracy, Dubai, UAE, 3-5 February 2008

The 4th Congress will be held at the Mina A' Salam Hotel, Madinat Jumeirah, Dubai, UAE.

This important Fourth Global Congress is being hosted by the World Customs Organization and Dubai Customs and convened by the other founding members of the Congress Steering Group.

In making the announcement, the WCO Secretary General, Michel Danet welcomed the support of Dubai Customs and stated that these Global Congresses (Brussels, Belgium 2004; Lyon, France 2005; and, Geneva Switzerland 2007) have become the premier international forum for shaping practical strategies to combat counterfeiting and piracy and that this was the first time that the Global Congress would be held outside Europe.

Danet said "The Congresses were aimed at promoting best practices and the sharing of information among and between enforcement agencies, the judiciary, policy makers and the private sector". He added that "The Fourth Global Congress is expected to identify concrete solutions to the global problems generated by the growth in counterfeiting and piracy and to further raise awareness of the ▸▸

World Customs Organization - Tackling Counterfeiting and Piracy Head On

The one million customs officers around the world who make up the combined force of all 171 members of the World Customs Organization have to deal with an annual flow of 400 million containers, and the number is increasing by 10% each year. This increase in world trade has generated an unprecedented surge in industrial counterfeiting, and it is against this backdrop that customs officers must gear up to urgently stem the tide of counterfeit and pirated goods which are washing over national borders. There is no denying that the international customs community has a real fight on its hands. Despite increasingly sophisticated control techniques, and greater awareness and commitment on the part of politicians at the international level, counterfeiting and piracy now form an integral part of the world of consumers albeit often unbeknown to them.

Anything that can be bought and sold is now being counterfeited: soup, mineral water, breast implants, contact lenses, toothpaste, sweets, jam, pharmaceutical products for treating life-threatening conditions such as breast cancer and high blood pressure, pacemakers, baby milk, weapons of war, automobile brake disc pads, and even a WCO training course on CD!

The days when 7 out of 10 companies falling victim to counterfeiters were in the luxury goods industry are long gone. Everything has changed in the past 20 years. In 2006, luxury goods accounted for only one percent of all the items intercepted by the 27 customs administrations of the European Union (EU). The number of IPR-infringing products seized at the external borders of the EU rose from 10 million in 1998 to 253 million in 2006. Between 2005 and 2006, the US Customs and Border Protection Agency reported an 86% increase in the number of products intercepted. As for the Chinese customs authorities, they have seen the number of counterfeit products seized double over the same period. These figures boggle the mind. There have been big changes in the nature of counterfeit and pirated goods, but the same can be said of the techniques developed by criminal organisations to transport these goods to their ultimate destinations. Direct carriage from the country of production to the point of consumption is virtually unheard of these days.

Today, counterfeit goods will cross several borders, or even several continents, passing from port to port and from airport to airport, changing ships or changing planes, using free zones and sometimes even switching transport documents or containers. All this subterfuge has one main priority: to conceal the true origin of the goods and thereby avoid attracting the attention of Customs and other border control services. This technique, commonly known as transhipment or break-bulk transit, is very widespread nowadays, and Customs services have had to adapt their control methods, shifting their focus away from the origin of the suspect goods to the point of dispatch and, in more general terms, the itinerary the goods follow.

While it is a fact that almost 80% of counterfeit or pirated goods originate in the Far East, the ever-increasing volume of commercial traffic, the changing nature of products and the new routes used for fraudulent activities, have forced customs administrations to adapt their control techniques if they are to successfully mount a challenge to this illegal activity. The approach used now involves studying the transport documents for each consignment in order to quantify the potential risks. This new approach ticks all the boxes for what is in fact the primary mission of a customs service, namely, to facilitate international trade while conducting controls on the movement of goods. Through this more thorough approach, customs administrations hope to secure the trade supply chain to ensure the safety of world trade and in doing so contribute to the alleviation of poverty while playing a major role in the promotion of economic prosperity and social development across the globe.

serious impact this illegal trade has on the health and safety of consumers". He also stressed that "organized crime is heavily involved in this underground and lethal economy that could only be fought collectively and through extensive international cooperation".

First Global Congress on Combating Counterfeiting and Piracy, World Customs Organization Headquarters, Brussels, Belgium, May, 2004

The World Customs Organization and Interpol, with the support and participation of the World Intellectual Property Organization, hosted the First Global Congress on Combating Counterfeiting. The Congress was held in co-operation with the Global Business Leaders Alliance Against Counterfeiting (GBLAAC), the International Trademark Association (INTA) and the International Security Management Association (ISMA).

The purpose of this first Congress was to develop a collective understanding of the extent of the counterfeit problem; identify effective measures adopted by governments and the private sector; generate ideas for further private/public sector co-operation; and, begin to identify solutions that would make a real difference in the coming decade.

There was an urgent need for staging a Global Congress. The worldwide trade in counterfeit products had been increasing dramatically in size and scope. Counterfeiting and piracy represented real threats to global security, consumer health and safety, economic development and good governance.

The Congress provided an opportunity for leaders from the public and private sectors to analyze the social and economic impact of counterfeiting and shape future enforcement strategies and actions. The program was organized as a high-level, interactive event. It included keynote addresses, plenary sessions and roundtables structured in a way that helped generate constructive debate and, ultimately, concrete recommendations on new methods and initiatives for addressing counterfeiting at the national, regional and global levels.

Discussions focused on the following:

- Developing a consensus on the full dimensions and related costs of counterfeiting to consumers, governments and industry.
- Developing common understandings of the prevailing attitudes of governments, the private sector and consumers towards counterfeiting.
- Generating common understandings of what is being done and what more needs to be done in the fight against counterfeiting.
- Examining and understanding current international instruments for co-operation among governments in enforcement work, and identifying enhancements required for strengthening enforcement efforts.

Second Global Congress on Combating Counterfeiting and Piracy, INTERPOL, Lyon, France, November 2005

More than 500 participants from 66 countries attended the Second Global Congress on Combating Counterfeiting and Piracy, which was co-hosted by Interpol and the World Customs Organization (WCO) and supported by the World Intellectual Property Organization (WIPO) and the private sector Founding Members of the Global Congress Steering Group.

Although data since the First Congress showed that the international trade in counterfeit and pirated products had continued to rise alarmingly, the Congress highlighted a number of positive developments. The success of Interpol's Operation Jupiter in Latin America, for example, had provided a model for transnational enforcement operations. A growing political commitment was evidenced by the G8 statement on counterfeiting and piracy at the July 2005 Gleneagles meeting; and by the support for the work of the Organization for Economic Cooperation and Development (OECD) to produce a comprehensive global study on counterfeiting and piracy. Public awareness of the implications of buying fake or pirated goods was growing in many countries where governments and business organizations were running high profile campaigns. And a report released in 2005 by the music industry group IFPI showed sales of digital music from legal sites to be surging, while illegal downloading figures remained flat.

The Congress concept had emerged as an important and valuable opportunity for national, regional and global leaders from the public and private sectors to raise awareness enhance cooperation and identify strategies to deal more effectively with the global problem of counterfeiting and piracy. However, he Congress Steering Group was under no illusion as to how much more must be done if the tide of counterfeiting and piracy activities was to be turned. The Second Congress focused on the four key areas identified in the First Congress and the subsequent Regional Congresses. Within each Focus Area, participants identified specific policy initiatives and priority actions.

Third Global Congress on Combating Counterfeiting and Piracy, World Intellectual Property Organization, Geneva, Switzerland, January, 2007

The Third Global Congress on Combating Counterfeiting and Piracy was convened by the World Intellectual Property Organization (WIPO), the International Criminal Police Organization (Interpol) and the World Customs Organization (WCO) in cooperation with the Global Business Leaders Alliance Against Counterfeiting (GBLAAC),

Risk analysis or targeting enables customs to conduct fewer, but more effective controls. Proof of this lies in the fact that the proportion of goods subjected to physical inspection at the EU borders stands at 3%, meaning that around 97% of goods are not inspected at all. However, fewer controls do not mean fewer results, as evidenced by the European statistics quoted earlier: Customs seizures of counterfeit products rose from 10 million in 1998 to almost 253 million in 2006, without any increase in the number of controls. This leads us to the question of whether the increase in the number of products intercepted can be put down to the pertinence of the controls or the increased production of counterfeit goods. In 2003, the World Economic Forum in Davos concluded that this traffic was worth about 500 billion US dollars, but who knows where this money ends up or what it will be used for - financing a major terrorist attack perhaps, destabilising the economy of a fragile state, fermenting civil war, or even fuelling the degrading drug trade. The horrors of what this "bad" money can do are endless!

Combating counterfeiting and piracy is a priority for the WCO and its members – a fact confirmed at the most recent sessions of the WCO Council which met in June 2007. To assist its 171 members to combat counterfeiting and piracy more effectively, the Council adopted a number of new initiatives, both legislative and operational, in the shape of two important "living" instruments: the SECURE Programme (Standards Employed by Customs for Uniform Rights Enforcement) and an Action Plan. This Programme will serve as a consolidated platform to promote better compliance with intellectual property rights at borders by building Customs capacity and strengthening co-operation with its international partners and rights holders.

Built around three key areas, namely, the development of an IPR legislative and enforcement regime, risk analysis and intelligence sharing; and capacity building for IPR enforcement and international cooperation, the Standards contained in the SECURE Programme rest on three pillars: Customs-to-Customs cooperation; a Customs/Rights Holders partnership; and a Customs interface with other public and private entities engaged in the fight against counterfeiting and piracy. The accompanying Action Plan which is designed to serve as a practical tool to implement the ideals of the SECURE Programme will facilitate operational customs activities to fight this growing illegal trade head on. Protecting consumer health and safety is a vital mission for customs administrations across the globe and it is important that WCO members equip themselves with new laws and enhanced operational instruments offering practical responses which are commensurate with the risk that counterfeit and pirated products pose. ■

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the International Trademark Association (INTA), the International Chamber of Commerce (ICC), and the International Security Management Association (ISMA).

Each year since its inception the Global Congress has been hosted on a rotating basis by the respective lead IGO. The 2007 Global Congress was hosted by WIPO and was held on January 30 and 31, 2007, in Geneva, Switzerland. Representatives of 107 countries participated and over 1,000 delegates attended.

Extending from recommendations made at the First Global Congress (Brussels, May 2004), the purpose of the Congress has been to raise awareness on the growing counterfeiting and piracy problems, share relevant information, develop strategies to combat the illegal trade and identify practical actions and potential solutions. The Lyon Declaration, developed at the Second Global Congress in 2005, identified four priority areas which have come to serve as the Congress's mandate and outline for action.

These four priorities are: (1) Raising Awareness; (2) Improving Cooperation and Coordination; (3) Building Capacity; and, (4) Promoting Better Legislation and Enforcement.

Drawing from this outline, the Third Global Congress was organized to enable participants to analyze progress made and suggest actions oriented towards the remaining challenges in each of the priority areas. Notably, the Congress also featured a special session on health and safety risks associated with counterfeiting and piracy; and this focus will become a fifth pillar of the Congress' priority focus. In the course of the presentations and discussions, a number of suggestions were made and proposals announced on how the various stakeholders might more effectively combat counterfeiting and piracy.

Regional Congresses

1. Rome
2. Shanghai
3. Rio de Janeiro
4. Bucharest

The Global Congress Steering Group has partnered in, and supported, four Regional Congresses. These Regional Congresses have been important venues in identifying regional and anti-counterfeiting and anti-piracy national opportunities and vulnerabilities and strengthening cooperation and coordination among enforcement agencies.

Role of the World Intellectual Property Organization (WIPO) in Combating Counterfeiting and Piracy

With headquarters in Geneva, Switzerland, WIPO is one of the 16 specialized agencies of the United Nations. It is dedicated to promoting and protecting intellectual property (IP) rights - such as copyright, trademarks, patents and industrial designs - as a means of rewarding creativity, stimulating innovation and contributing to economic development. As WIPO Deputy Director General, Michael Keplinger, wrote in a recent edition of WCR, "the protection of property rights is one of the keystones of a free and flourishing society. Protecting IP from unauthorized use and ensuring that creators, rights holders and governments reap the full benefits offered by the IP-based industries is a top priority at both national and international levels. And never before, in WIPO's 35-year history, has IP occupied such a central position in economic, cultural and political life."

Counterfeiting and piracy undermine the health of national economies. They stunt the growth of small and medium-sized enterprises. They divert tax revenues from the public coffers into the pockets of free-riders. They deter investment and innovation. They pose significant threats to public welfare, often violating employment health and safety legislation. Furthermore, the trade in counterfeit and pirate products also often has close ties with organized crime.

As the primary intergovernmental organization charged with the protection of IP rights, WIPO has a pre-eminent role in facilitating cooperation between governments, organizations and the private sector to combat the abuse of these rights through counterfeiting and piracy.

Working jointly with member states, industry representatives and other stakeholders, WIPO aims to assist in developing effective anti-counterfeiting and piracy strategies, with a focus on providing legislative assistance, raising awareness, improving international coordination, and building capacity.

WIPO's 184 member states and some 250 observer organizations meet regularly in the Advisory Committee on Enforcement (ACE). The main objectives of the Committee are to enhance information exchange between law enforcement agencies, assess training and education needs, and develop teaching materials and methodologies which contribute to improved legal, organizational and technical frameworks for the effective enforcement of IP rights.

Increasingly, governments are of the view that it is in their national interests to pass laws that protect IP and to provide efficient mechanisms for enforcing these laws. To this end, WIPO responds to a growing number of requests from governments for expert legislative advice on the protection and enforcement of IP rights.

Training for law enforcement agencies in all regions of the world are a key part of the work under taken by WIPO. In 2007 alone, WIPO organized 20 seminars and workshops in 13 countries. These training programs bring together judges, magistrates, customs and police officials, IP attorneys, and representatives from IP offices, the business community and consumer groups from the host country and other countries in the respective regions so that all involved gain a better understanding of each other's roles. The active involvement of the private sector is a cornerstone of the success of much of this training. As part of its capacity-building activities, WIPO has also produced major case books for use as reference works by judges and lawyers, as well as an extensive database of enforcement cases.

WIPO further facilitates the exchange of information between right holders and major stakeholders through a dedicated online enforcement forum (IPEIS) hosted by the WIPO website. The website also offers access to information on enforcement issues at national and regional level through providing a Portal to Member States online information. Quarterly enforcement newsletters provide regular updates on global developments.

WIPO also responds on many levels to the constant demand from Member States for assistance in developing public awareness-raising activities and materials designed to deter consumers from buying counterfeit and pirated goods. The WIPO Outreach Guides include practical advice on planning anti-counterfeiting and piracy campaigns, with examples drawn from across the world. The WIPO Magazine contains regular feature articles on trends, initiatives, case-studies and resources in the field of enforcement. WIPO also produces short films and webcasts in which musicians, film-makers and artists talk about their creative work and how piracy impacts on them. World Intellectual Property Day each day offers an increasingly popular platform for governments and organizations to mount high profile awareness-raising events.

No business, organization or government can combat the global problems of piracy and counterfeiting in isolation. WIPO therefore continues to work in multiple fora to foster international cooperation in tackling the shared challenges.

For more information on the WIPO's activities in the area of enforcement, see www.wipo.int/enforcement/en/

Rome – October 2004

The International Conference of Rome provided an important opportunity for global leaders from the public and private sectors to enhance cooperation and build upon the common strategies that were identified in the First Global Congress on Combating Counterfeiting held in Brussels earlier in this year.

Shanghai – November 2004

The Global Congress/WCO Asia Pacific Regional Forum on the Protection of Intellectual Property Rights provided an important venue for customs administrations from the Asia/Pacific region, and global representatives from the public and private sectors, to enhance cooperation and identify areas for improving synergy and action. All participating Asia Pacific countries considered the protection of IP rights as key to economic development and agreed to continue to enhance their efforts to make IP enforcement more effective.

Rio de Janeiro – June 2005

The Global Congress/Latin America Regional Forum on Combating Counterfeiting and Piracy was co-hosted by the Government of Brazil and Interpol. All participating Latin America countries considered the protection of IP rights as key to economic development and agreed to continue to enhance their efforts to make IP enforcement more effective.

Bucharest – July 2006

The Eastern Europe and Central Asia Regional Congress on Combating Counterfeiting and Piracy was co-hosted and sponsored by the Government of Romania and WIPO.

Participants agreed that the counterfeiting and piracy problem was dramatically growing in size and scope and posed significant threats to global trade, national economic growth, consumer health and safety and is a leading cause in the growth of organized crime and corruption. Delegates agreed that the promotion and protection of Intellectual Property Rights was a key element of economic stability. Effectively protecting the IP Rights of owners, innovators and artists is critical for sustainable economic growth.

Consolidated Summary of Recommendations

Overview

Over the past three years, the Global Congress on Combating Counterfeiting and Piracy has conducted three Global Congresses (Brussels – May 2004, Lyon – November 2005, Geneva – January 2007) and four Regional Congresses (Rome – October 2004, Shanghai – November 2004, Brazil – June 2005, Romania – July 2006). At each of the seven events, the recommended actions were captured and catalogued.

The following are just a few of the key recommendations emanating

INTERPOL - Intellectual Property Crimes: Trademark Counterfeiting & Copyright Piracy

Trademark counterfeiting and copyright piracy: involvement of transnational organized criminals

Trademark counterfeiting and copyright piracy are serious Intellectual Property (IP) crimes that defraud consumers, threaten the health of patients, cost society billions of dollars in lost government revenues, foreign investments or business profits and violate the rights of trademark, patent, and copyright owners. Fake products pose a significant safety threat to consumers worldwide. Unsuspecting customers and patients put their health, and even lives, in jeopardy each time they use fake medicines, alcoholic beverages, food products and travel in automobiles or aircraft maintained with substandard counterfeit parts.

Transnational IP crime knows no boundaries and is evident all over the world. Evidence shows that transnational organized crime groups are actively involved in trademark counterfeiting and copyright piracy. These crimes are linked with money laundering, the illicit trafficking of drug, firearms and other types of organized crime. In some instances paramilitary terrorist organizations have traded in counterfeit and pirated goods to maintain their organizations and fund their activities.

Worldwide losses caused by the involvement of transnational organized criminals in fake product manufacture and distribution are estimated to be hundreds of billions of dollars annually. The social, health and economic damages arising from the production and sale of fake products are substantial. There are many victims of transnational organized IP crime including people suffering from life threatening diseases who unknowingly use counterfeit medicines containing little or no active ingredients.

Interpol's initiative to combat IP crime

Stakeholders in the fight against transnational organized IP crime are not just consumers, patients and IP owners, but also governments, the judiciary, the media and law enforcement authorities. Law enforcement authorities, including national police forces, are at the forefront of collective efforts to combat the activities of transnational organized criminals.

However, there is often a lack of trained investigators and other resources needed to effectively address transnational organized IP crime. There is an urgent need for national and international enforcement authorities to coordinate their efforts and cooperate with the IP right holders in the private sector.

In October 2000, the Interpol General Assembly approved the addition of IP crime to the Organization's official mandate. Shortly afterwards, the Interpol Intellectual Property Action Group (IIPCAG) was formed as a public-private partnership. Core membership of the Action Group consists of representatives from national law enforcement and customs authorities, international intergovernmental organizations, cross-industry private sector representative bodies and patent protection entities.

The Actions Group's mission is to provide an advisory group function; assist Interpol to develop strategies to combat transnational organized IP crime; and, encourage National Central Bureaus (NCBs) and national law enforcement authorities in Interpol member countries to dedicate more resources to IP crime enforcement.

Interpol's Intellectual Property Crime Program

The Interpol IP Crime Program is constantly evolving to meet challenges posed by transnational organized crime. Combining the efforts of Interpol and IIPCAG has broadened and strengthened partnerships with the private sector to improve the effectiveness of collective action to expand Interpol's capacity to tackle trademark counterfeiting and copyright piracy.

Interpol IP Crime Program objectives:

- Develop strategies and programmes to combat transnational organized criminal activity linked to IP infringement
- Develop the Database on International Intellectual Property (DIIP) crime to improve the exchange of information and intelligence on transnational organized IP crime
- Raise awareness among policy makers, stakeholders and the public about the central role of organized criminals in transnational IP crime
- Increase national and regional law enforcement efforts to combat transnational organized IP crime
- Develop a systematic worldwide operational capability to facilitate and coordinate regional enforcement action against transnational IP crime
- Provide police with support and training on IP crime

Interpol and IIPCAG members work together in partnership to achieve these objectives. They also have identified the following priorities:

from the Global and Regional Congresses held to date. The full set of recommendations from each of the Congresses can be found on the Global Congress website at www.ccapcongress.net

Recommendation highlights

Key focus area #1 - raising awareness

Throughout the Congresses many speakers and delegates have addressed the need to increase public and political awareness and understanding of counterfeiting and piracy activities and the associated economic and social harm. They have also agreed some priority should be given to educating young consumers. Greater steps in raising awareness can lead to informed consumers that better understand harms associated with purchasing and consuming counterfeit and pirate goods; likewise, informed policymakers have sufficient information to make decisions, implement policies and allocate resources.

- Support the completion of global studies on the economic and social impacts of counterfeiting and piracy such as the OECD study, the first part of which was to be published in the Spring of 2007. Make wide use of the results to inform policy makers, law enforcement agencies, and the public at large.
- Further increase awareness raising efforts at all stakeholder levels (ie politicians, enforcement, consumers) to raise political will.
- Support awareness raising efforts among law enforcement agencies to ensure that counterfeiting and piracy at a commercial scale are perceived and dealt with as serious crimes.
- Increase consumer awareness campaigns in order to target the "demand side" of the counterfeit and piracy problem. Campaigns should focus on possible health and safety risks for the individual consumer, and the dangers to the public order caused by organized crime involvement.
- Focus awareness campaigns that address young people, and involve them in the design of such campaigns.
- Start consumer education on the consequences of counterfeiting and piracy as early as possible, preferably at pre-school or school level.
- Design specific awareness campaigns that address the illiterate.
- Develop a coordinated global program to build public awareness of the impacts of counterfeiting and piracy among policy-makers, opinion leaders and consumers, including but not limited to education on the risks and costs of counterfeiting and piracy.
- Encourage business and enforcement agencies to publicize seizures as a means of raising awareness of the media and consumers about the negative economic and social impacts of counterfeiting and piracy.
- Call upon all Governments at the highest levels to place a greater priority against counterfeiting and allocate additional resources in the fight against it.
- Produce regular reports to stakeholders on progress made on the Congress recommendations and new initiatives, particularly with regard to:

  - Threats posed by organized criminal networks;
  - Threats to global security;
  - Threats to consumer health and safety.

- Encourage the participants in the Congresses to urge governments, organizations and institutions to be aware of, and, where appropriate, to implement the conclusions and recommendations of the Congress.

Information exchange and maximizing benefits arising from DIIP

- The Database on International Intellectual Property (DIIP) crime is designed to identify links between transnational cross-industry organized IP crime activity and other types of organized crime. It is used to inform and facilitate law enforcement interventions in transnational organized IP crime
- It will lead to the development of a systematic Interpol regional operational capability to facilitate and coordinate collective efforts to identify and disrupt transnational organized IP crime networks
- It will be used to produce regional and global strategic IP crime reports
- It will improve the information flow between stakeholders and lead to more effective national and regional IP rights enforcement

Development of systematic Interpol regional operational capability

Interpol facilitates and coordinates regional law enforcement interventions in transnational and organized IP crime. Since 2004 Interpol has acted as a catalyst for interventions into transnational organized criminal activity in South America and South East Asia. Partnership action with national police and customs agencies supported by affected private sector entities has led to the arrest of hundreds of suspects and seizure of millions of dollars of counterfeit and pirate goods. It has also led to the identification and disruption of a criminal conspiracy producing counterfeit medicines on an industrialized scale and undermining legitimate efforts by regional health authorities to cure patients suffering from life threatening diseases.

The development of DIIP and increased flow of information for action will result in a more systematic Interpol regional operational capability to facilitate and coordinate law enforcement interventions in transnational organized crime.

Training

- Identify international operational and strategic training needs at national and regional levels
- Develop clear, consistent and specialized IP crime training programmes incorporating information from both the law enforcement community and the private sector
- Provide students and trainers with ready access to public and private sector training programmes and materials including the Interpol Guide to Intellectual Property Crime and Investigations

Contact point

- Provide a central point of reference for transnational organized IP crime at the Interpol General Secretariat to facilitate contacts between law enforcement and industry IP crime investigators
- Develop reliable support services for collective efforts by IP crime investigators to combat transnational organized IP crime and improve communication
- Act as a collection point for information obtained from all available sources for input into DIIP to support regional law enforcement interventions into transnational organized IP crime

Public awareness

- Formulate effective strategies to increase global awareness of the negative impact of transnational organized IP crime
- Identify key audiences and create communication programmes aimed at governments, law enforcement bodies, customs, consumers, patients, private sector and media
- Showcase transnational organized IP crime success stories as case studies in public awareness programmes, training materials and on the Interpol IP crime website ■

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Website: www.interpol.int

Key focus area #2 - improving cooperation and coordination

There was general consensus at the Congresses that the global problems of counterfeiting and piracy could not to be solved by individual governments, business sectors or companies because the trade is global. Therefore, it is critical to increase and improve the cooperation and coordination among and between these sectors.

- Establish better cooperation and coordination among countries that are interested in more effective and efficient enforcement of IP rights with the aim of harmonization or at least approximation of laws and procedures.
- Encourage focused cooperation between national governments to set up effective standards at the sub-regional, regional and/or international level to combat counterfeiting and piracy.
- In cooperation with the private sector, establish special units/task forces in national administrations that would serve as focal points for the coordination of anti-counterfeiting and anti-piracy activities, specifically data collection and information sharing.
- Establish task forces/procedures that facilitate communication and cooperation between the private sector and governments.
- Encourage national governments to set up IP focal points in their respective embassies.
- Where appropriate, and in partnership between the public and private sectors, establish anti-counterfeiting/anti-piracy help-desks to support and provide information to local businesses and those investing abroad.
- Put in place clear regulations or, where more appropriate, guidelines for cooperation procedures amongst governments, their agencies and the private sector.
- Strengthen cooperation between customs authorities and the private sector by providing simple and free-to-use mechanisms for customs registration, in particular to help small and medium-sized enterprises (SMEs) to use the system.
- Encourage the further development and wide use of databases that provide IP enforcement-related information, including, for example, the WCO Customs Network (CEN), and the Interpol Database on International Intellectual Property Crime (DIIP).
- Promote the exchange of intelligence at the international and regional levels to respond to the increasingly sophisticated criminal networks driving counterfeiting and piracy.
- Continue to support and further develop concerted regional action against counterfeiting and piracy such as Interpol's Operation Jupiter.
- Establish a cross-industry clearinghouse for companies, large and small, to share their corporate strategies against counterfeiting and piracy, such as best practices, both throughout industry sectors and with governments.
- Design protocols on the exchange of IPR information between enforcement authorities and rights holders.
- Encourage countries to modernize their Customs legislation on border measures for IP protection, taking into account the WCO Model Law (published on the website www.wcoipr.org) to further enhance anti-counterfeit capabilities, specifically by:

  - Reducing or eliminating the requirement for IP owners to pay bonds for counterfeiting cases;

  - Facilitating further simplification of procedures for obtaining court orders; and,

  - Empowering customs officials to conduct in-depth investigations into counterfeiting and piracy cases.
- Establish regional public/private sector initiatives on counterfeiting.
- Conduct a private sector summit meeting of the many trademark owner groups and organizations working on the counterfeiting issue. The aim of this summit is to develop plans for better coordination and collaboration among these groups, to more clearly define roles and responsibilities and to identify efficiencies.

Key focus area #3 - building capacity

The Congresses have recognized that a country's effectiveness in protecting IP rights is dependent upon its capacity to do so. Therefore, in addition to prescriptions for better legislation, stronger enforcement and penalties, speakers and delegates have also suggested methods for improving knowledge, training and skill capacities.

- Identify deficiencies and duplication and explore partnerships to respond more effectively to the strong demand for capacity building at all levels concerned with the enforcement of IP rights. In particular, efforts should be focused on the sufficient resourcing for services rendered by the judiciary, the prosecution, police and customs officials to ensure effective implementation of anti-counterfeiting and ant-piracy legislation and enforcement procedures.
- Encourage national governments to sufficiently equip their IP enforcement units to enable efficient enforcement action and effective sanctions against counterfeiting and piracy.
- In the framework of activities aimed at capacity building, pay particular attention to the many links and overlaps between the enforcement of IP rights and the enforcement of law in general. The above is intended to assist in identifying and fostering synergies between law enforcement, in general, and IP enforcement, in particular.
- Provide better information on the relationship between the level of counterfeiting and piracy in a country and the perceived level of corruption.
- As a response to the increasingly sophisticated counterfeiting and piracy businesses, explore the appropriate use of security and authentication technologies.
- Design training programs according to the particular needs and circumstances of the geographic location and the target group ("tailor-made solutions").
- Cooperate more closely with right holders for the purpose of better identifying counterfeit and pirated goods at borders.
- Support the use of e-learning programs, for example the WCO e-learning modules on anti-counterfeiting and the entire distance learning programs of the WIPO Worldwide Academy.
- Intensify coordination and cooperation among International Government Organizations (IGOs) and Non-Government Organizations (NGOs) to further improve practical training programs on IP protection and enforcement for law enforcement officials.
- Encourage companies to develop anti-counterfeiting/piracy codes

BASCAP – An Initiative of the International Chamber of Commerce

The International Chamber of Commerce launched BASCAP – Business Action to Stop Counterfeiting and Piracy – to unite the global business community across all product sectors, address issues associated with intellectual property theft and petition for greater commitments by local, national and international officials in the enforcement and protection of intellectual property rights. In its first phase, BASCAP has created a set of tangible products that greatly improve the transparency and exchange of information and facilitate connections between industry players, policymakers and enforcement officials. The current focus is now on setting standards for global performance by governments and companies; framing decisions for policymakers; pushing for the allocation of resources at the highest levels in national governments; and, improving awareness on a global basis. BASCAP features a Global Leadership Group comprised of CEOs, Chairmen and senior corporate officials to build awareness and amplify messages to national governments

For more information, contact Jeff Hardy (jhd@iccwbo.org) or visit www.iccwbo.org/bascap

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of conduct and establish supply chain standards.

- Establish a study group to investigate and recommend how enforcement authorities and business can better deal with the growing problem of sales of counterfeit and pirated products over the internet.
- Develop a comprehensive program of IPR technical assistance and capacity building for enforcement authorities including the exploration of funding sources.

Key focus area #4 - promoting better legislation and enforcement

Speakers and delegates at the Congress called on countries to further improve civil, administrative and penal provisions in legislation dealing with the enforcement of IP rights, to streamline procedures and to allocate more resources to improve the enforcement of intellectual property rights, by both adhering to international standards and implementing and enforcing effective national and regional IP protection regimes. There was general consensus at the Congresses that even if good laws are in place, they are often poorly enforced.

- Consider providing for criminal sanctions for commercial scale IP violations, which fully reflect the current dimension of counterfeiting and piracy and to underline that they are serious economic crimes.
- Encourage the review of sanction structures to ensure that they are strong enough to serve as effective deterrents, and encourage courts and competent administrative authorities to use criminal sanctions
- Examine whether, and under which circumstances, consumers should also be penalized for purchasing and/or possession of counterfeit and pirated products in countries that don't already have such measures.
- Encourage countries to strengthen civil remedies and procedures, such as effective provisional measures, and provide more adequate compensation for rights holders through appropriate methods for the calculation of damages.
- Analyze and, as appropriate, eliminate jurisdictional inconsistencies concerning judicial interpretation of law, for example in the context of the release of goods and the issue of parallel importation.
- Encourage governments to further develop and clarify legal standards for the availability of civil remedies, including damages and their calculation, and procedural law.
- Reduce litigation costs for the use of the civil system to enforce IP rights.
- Take appropriate measures to ensure Free Trade Zones provisions are not unfairly and illegally manipulated by counterfeiters

The International Trademark Association (INTA)

The International Trademark Association is a not-for-profit membership association of more than 5,000 trademark owners and professionals, from more than 190 countries, dedicated to the support and advancement of trademarks and related intellectual property as elements of fair and effective national and international commerce.

INTA was founded in 1878 by 17 merchants and manufacturers who saw a need for an organization "to protect and promote the rights of trademark owners, to secure useful legislation and to give aid and encouragement to all efforts for the advancement and observance of trademark rights." After 129 years, INTA continues its mission to represent the trademark community, shape public policy and advance professional knowledge and development.

INTA believes strongly that nations must work together and exchange information and ideas that will eliminate the threat posed by cheap, fake goods that illegally play on the good name of legitimate trademarks. With this belief, INTA strongly advocates policies to advance protection against trademark counterfeiting and infringement. In doing so, INTA analyzes and comments on treaties, laws, regulations, procedures and other enforcement mechanisms with respect to anti-counterfeiting; engages and works with other anti-counterfeiting associations and coalitions at all levels, and with governmental officials all over the world dealing with anti-counterfeiting issues; and educates through government roundtables, forums and publications on anti-counterfeiting.

In 2006, INTA won the eighth annual Global Anti-Counterfeiting Award, sponsored by the Global Anti-Counterfeiting Group (GACG) Network, for the work INTA has done to significantly raise the level of its activities both internally in the form of the Anti-Counterfeiting and Enforcement Committee and, most importantly, externally using its global influence and contacts to energize co-operation on intellectual property rights enforcement. Notable among its recent achievements are participation and leadership for the Global Congress on Combating Counterfeiting and Piracy and the various Regional Forums; support and resource to the Organization for Economic Cooperation and Development study on the economic impact of counterfeiting; input and initiatives on several consultations for new legislation; and organization and participation in various awareness-raising events.

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International Security Management Association (ISMA)

The International Security Management Association, founded in 1983, is a premier international security association of senior security executives from major business organizations located worldwide. ISMA's mission is to provide and support an international forum of selected security executives whose combined expertise will be utilized in a synergistic manner in developing, organizing, assimilating, and sharing knowledge within security disciplines for the ultimate purpose of enhancing professional and business standards.

ISMA provides opportunities to network with other senior security executives and to establish a leadership forum to provide personal and professional growth opportunities. Members benefit from semi-annual workshops held in major cities around the world. Workshops focus on security, business, and leadership issues to include a members' forum which generates open discussion on a variety of security, management and other relevant topics. One of the greatest benefits of ISMA membership is the opportunity to develop professional and personal relationships with other leaders in the international security community. These relationships benefit the company as well as the member.

- Elaborate rules for Free Trade Zones to facilitate seizures of counterfeit and pirated goods and to prevent the trade in counterfeit and pirated goods, most particularly by eliminating the practice of disguising the origin of products.
- Establish legislative standards on prohibiting the movement of counterfeit and pirated goods that are in transit or in the transhipment process.
- Explore options for improvement in international legal framework systems for sanctions against IP crimes, either separately or in connection with another international instrument, eg, on organized crime in general.
- Formulate and/or finalize guidelines for global protection of IP rights, such as the WCO Framework of Standards, and promote and support their wide adoption by governments to further strengthen national customs administrations in their efforts to combat counterfeiting and piracy.
- Develop a set of good practices to ensure that legitimate businesses are made aware of the serious consequences of participating in the production, shipment, distribution and retailing of counterfeit and pirated goods.
- Encourage the introduction of legislation to strengthen the effectiveness of the present enforcement measures, in particular:

  - Allowing the destruction, or disposal at the right holder's consent, of seized counterfeit goods at the earliest possible moment;

  - Establishing statutory minimum damages for trademark counterfeiting;

  - Imposing punitive damages within pre-established criteria as a deterrent measure;

  - Imposing effective jail time at least to repeated offenders and in aggravating circumstances.

Key focus area #5 - health and safety risks

While previous Congresses considered the serious implications of counterfeit products on consumer health and safety, delegates at The Third Global Congress determined it should become the fifth pillar or key focus area.

The Third Congress widely recognized that counterfeiting and piracy harm society in many ways that are often overlooked when an assessment of the consequences is primarily focusing on the economic impact. This is particularly true for counterfeit products that are not tested to the same safety standards and can therefore be dangerous for consumers. In addition to health hazards presented by fake auto parts, electrical goods, foods and toys, speakers and delegates addressed the growing problem of counterfeit pharmaceuticals and drew particular attention to the fact persons in need of medication often acted in good faith and were not aware of, and therefore not in the position to assess, the risk.

- Encourage governments to establish well-equipped and competent national drug regulatory authorities that will ensure control and regular inspection of entities involved in the manufacture, trade and distribution of pharmaceuticals.
- Encourage governments to establish legislation that the manufacture and distribution of counterfeit drugs are punishable as serious, potentially life-threatening crimes.
- Better coordinate, at the national, regional and international levels, preventive and investigative efforts by involving drug regulatory authorities, law enforcement agencies, manufacturers of pharmaceuticals, professional associations of medical practitioners and pharmacists, as well as consumer protection groups, to strengthen concerted action against the manufacturing and distribution of counterfeit pharmaceuticals.
- Establish strict regulations for licensing wholesalers to ensure maximum control of legitimate supply chains of pharmaceuticals, car parts and other sensitive merchandises.
- Monitor the internet and take action whenever possible and appropriate to discourage the distribution of fake pharmaceuticals, as well as the illegal supply of narcotic drugs.
- Support international authorities such as the International Narcotics Control Board (INCB) in developing guidelines for governments to counteract the spread of illegally operating internet pharmacies.
- Liaise with enforcement agencies working against fake narcotic drugs to explore synergies and disclose links between the manufacturing and distribution of counterfeit pharmaceuticals on the one hand, and that of fake narcotic drugs on the other.
- Raise awareness among consumers on the dramatic level of health and safety risks resulting from the use of counterfeit drugs, fake car parts or electric or electronic devices.
- Encourage companies to improve the packaging of pharmaceuticals to make counterfeiting more difficult.
- Further strengthen cooperation between all stakeholders involved in the fight against counterfeit drugs, including supporting the work of the WHO International Medical Products Anti-Counterfeiting Taskforce (IMPACT).
- Support the further collection and updating of data to continue to assess the full extent of health and safety risks for consumers from counterfeiting and then assist in communicating this information to policy-makers, law enforcement agencies, and the public.
- Intensify training of law enforcement authorities, especially customs administrations, that focus on counterfeit products posing health and safety risks. ■

Dubai Customs

Dubai Customs is one of the ancient government departments known as "Al Furdha (taxes on all imported goods). As it had been firmly established, Dubai Customs was the so-called "Mother of Government Departments", particularly as some of the existing departments were based at the old customs building and financed from the revenue collected by customs. Dubai Customs, over its long history, which extends over one hundred years, passed through many stages. In the era of the late Sheikh Rashid Bin Said Al Maktoum, Ruler of Dubai, Dubai Customs started to adopt an institutional direction. The first floor of the customs old building was used by the Ruler of Dubai as his official office, reflecting the critical role of customs and its position in Dubai, which was renowned for its trade and traders. Keeping pace with the building and corporate development, Dubai Custom gained a regional and international image. By virtue of its advanced infrastructure and state-of-the-art management facilities and services, Dubai was a destination of choice for investors and businessmen. Dubai Customs, through its endeavour and drive, is now among the leading customs administrations in the world. ■

Bratislava: European City of the Future

Bratislava has always been slightly distinct from the rest of Slovakia. This is probably also due in part to its asymmetric position in the south-west corner of the country. It is therefore only natural that following 1989, and with the entry of Slovakia to the European Union, Bratislava is now a city with the best prospects to fast become a modern European metropolis with a high quality of life. With its geographic position, progressive infrastructure, and strong human capital, Bratislava could find itself swiftly turning into a natural crossroads of nations, cultures and trade in this part of Europe.

City on the Danube

While in 1990s, the emphasis in terms of regenerating the city environment was concentrated primarily on the tangible historic heritage in the city centre, the coming years will be marked by expansion of the attractive city environment, with the river representing a hub of the development. The vision is, finally, to make Bratislava a "City on the Danube" and not just a city along the Danube.

In the space of 3-4 years a 4 km riverbank promenade will appear on the Danube's north bank including new city districts called RiverPark and Eurovea. Across the river on the south bank the city has presented the new land use plan for the Petrzalka centre zone between The Old Bridge and The Harbour Bridge, which should boast several attractive elements, such as a multipurpose arena for around 12,000 spectators. It should serve for the Ice Hockey World Championship, scheduled to be held in Bratislava in the spring of 2011. Key train and bus station terminals will be completely revitalised over the next 4-5 years, as well as the infrastructure of the city's international airport.

Naturally, intensive urbanisation of Bratislava put greater demands on the development of transport infrastructure. The city has to resolve the expansion of the municipal public transport system on both sides of the Danube. The most realistic way to achieve this goal is to build a seven-kilometre long light rail from the south of the city to the centre. The city's priority programme also includes the start of work on the outer ringroad of the city.

New land use plan

All of these priorities are catered for also in the new land use plan. The development area on both banks of the River Danube, and the historical city centre have been pinpointed as of particular significance in Bratislava's urban concept. A special place is held by the dockland zone. Bratislava will also see its southwest develop, with increased promotion of territorial and commercial relations with municipalities on the Austrian side. Bratislava's new land use plan identifies 3,200 hectares of new development area for housing and civil amenities.

The excellent geographic location of Bratislava combined with its positive demographic vitality make the Slovak capital a unique place for the development of economic activity of every kind. It is hardly by chance that last year Bratislava found itself on the shortlist of European Property Awards for the first time in the coveted category of "European City of the Future". ■

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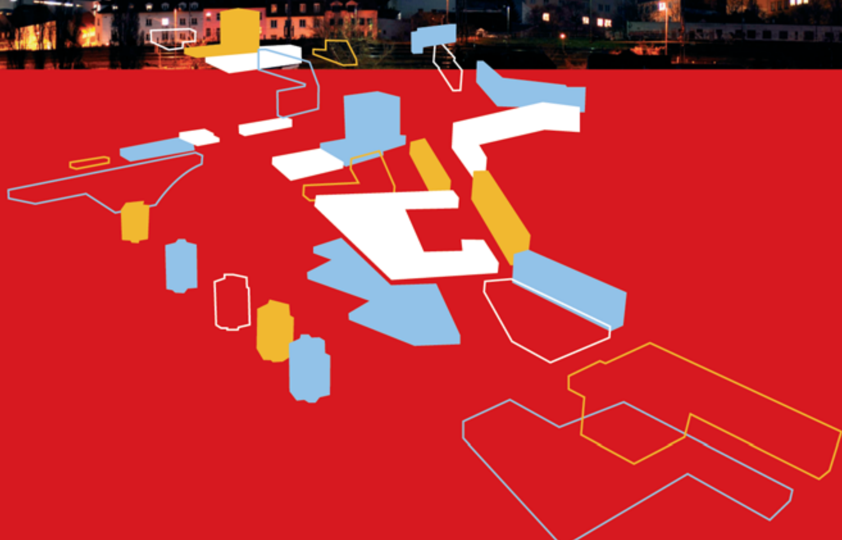
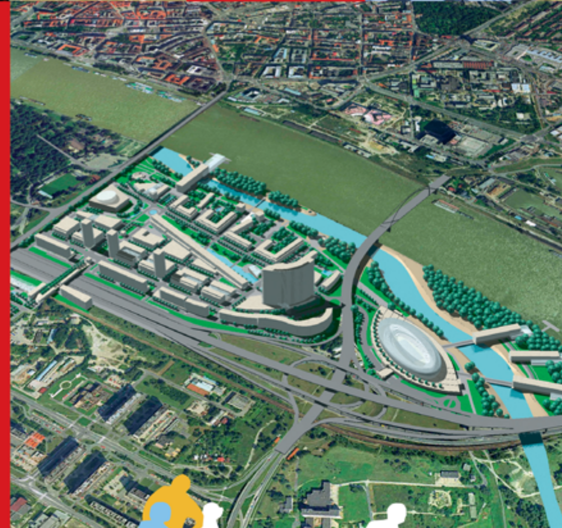
BRATISLAVA : CAPITAL OF SLOVAKIA

Bratislava is experiencing a long overdue boom in real estate development, with international developers and local financial groups announcing big plans to transform the city's appearance. More than one billion euros in investments are planned in one of the European cities of the future*.

The prospective development potential of the city is now encouraged by a New General City Plan. The 10th in the history of the city and the first since 1976 offers more than 4,000 hectares of new development areas.

Come and meet the vision Bratislava is expected to look in 20 years.

For more information on opportunities in Slovakia's capital city, visit us online at **www.cityofbratislava.eu** or contact us directly at **+421 2 59 356 155** or **marketing@bratislava.sk**.

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* City of Bratislava has been short-listed in the 2006 European Property Awards in the City of the Future category.

BRATISLAVA