

Proposed changes to EU Emissions Trading Scheme

February 2008

This Legal Alert highlights the main elements of the recent European Commission proposal (the “**Proposal**”) to amend Directive 2003/87/EC on the European Emissions Trading Scheme (the “**EU ETS Directive**”).

Background

In March 2007, the European Council adopted the objective to reduce greenhouse gas (“**GHG**”) emissions by 20% by 2020, as compared to 1990 levels. In addition, the Council endorsed an increased reduction objective of 30% by 2020 if other developed countries adopt comparable emission reduction commitments and economically more advanced developing countries also contribute to emission reduction in accordance to their responsibilities and respective capabilities.

On 23 January 2008, the European Commission presented the European Union Climate Action package, which includes the Proposal and a draft decision on the effort of Member States to meet the Community’s reduction commitments (the “**Effort-Sharing Proposal**”).

Main changes and issues

The Proposal and the Effort-Sharing Proposal contain two scenarios. The first scenario reflects the EU’s independent commitment to reduce its emissions (to at least 20% below 1990 levels by 2020); the second scenario increases this reduction to 30% in the context of an anticipated international post-Kyoto agreement to combat climate change.

Cap and linear decrease

The Commission will publish the absolute quantity of allowances available for 2013 not later than 30 June 2010. In the first scenario, the Proposal provides for a linear decrease in this quantity by 1.74% per year. This linear reduction path will arrive at a reduction of 21% below reported 2005 emissions by 2020 (approximately 1.72 billion allowances) and will continue beyond 2020. In the second scenario (i.e. if a new international agreement is reached), the linear decrease factor will be proportionally increased to meet the reduction commitment of 30%.

The Proposal provides for a new entrants reserve of 5% of the total quantity of EU allowances. The use of this reserve should reflect the allocation rules currently applied to existing installations. Allowances that remain in the reserve in 2020 are to be auctioned.

Auctioning and allocation free of charge

The basic principle for allocation of allowances from 2013 onwards will be auctioning. The Commission estimates that at least two-thirds of the total quantity of allowances will be auctioned by the Member States in 2013.

Allowances for the electricity production sector will be fully auctioned from 2013 onwards, except for heat production through high-efficiency cogeneration. New entrants to the electricity production sector will not receive any allowances for free, nor will they be able to benefit from the new entrants reserve.

A gradual transition will be applied to other sectors, starting with 80% allocation free of charge in 2013. This percentage would be reduced by equal amounts each year, finally reaching zero in 2020. The Proposal does not further specify the allocation principles. Should an international post-Kyoto agreement be concluded, then allocation free of charge will only take place if this can be justified under such agreement. Therefore, the allocation rules and quantities may be changed in the course of a trading period.

The Proposal does not contain clear auctioning rules for the Member States, nor does it specify how the quantity of allowances to be auctioned will be calculated and distributed among the individual Member States. The Commission is to adopt an auctioning regulation by 31 December 2010.

90% of the total quantity of allowances that are to be auctioned will be distributed among the Member States according to emissions reported in 2005 (or an average between 2005 and 2006). 10% will be distributed among certain Member States for the purpose of solidarity and growth, to reduce emissions and to adapt to climate change.

Carbon leakage

If no international post-Kyoto agreement is reached which requires third countries to adopt GHG reduction measures comparable to those of the EU, certain industry sectors may be induced to relocate GHG emitting activities from the EU to other countries, causing an increase in global emissions. To prevent such "carbon leakage", the Proposal provides for the possibility of allocating allowances free of charge to certain energy-intensive sectors that are subject to international competition. The Commission will identify which sectors are susceptible to carbon leakage by 30 June 2010 (this list shall then be reviewed every three years). In addition, a proposal will be presented by June 2011, based on an analysis report and the outcome of international negotiations.

As an alternative for allocation free of charge, the Proposal mentions the introduction of a carbon equalisation system, which may result, for example, in a carbon levy on goods produced in countries without emission caps. Such alternative, however, should comply with UNFCCC principles and

international obligations of the EU, such as the WTO agreement.

Exclusion of small installations

Member States may exclude small installations from the EU ETS if this improves the cost-effectiveness of their emission reduction efforts. Small installations are defined as combustion installations with a rated thermal input below 25 MW and reported emissions of less than 10,000 tonnes of CO₂-equivalent in each of the preceding 3 years (excluding emissions from biomass). Such small installations may be excluded from the EU ETS, provided that they are subject to other measures that will achieve equivalent emission reductions. The Proposal sets out the further conditions under which Member States may apply this exclusion.

Extended scope

The Proposal extends the scope of the EU ETS to new sectors and gases. GHG emissions from petrochemicals, ammonia and aluminium are proposed for inclusion, as well as N₂O emissions from the production of nitric, adipic and glyoxalic acids and PFC emissions from the aluminium sector.

Carbon capture and storage

To provide the necessary incentives for geological storage of emissions, there will be no need to surrender allowances for emissions stored. It is proposed that installations undertaking the capture, transport and geological storage of GHG be included in the EU ETS. The Commission has also presented a draft directive on the geological storage of CO₂ (the "CCS Proposal").

Aviation

It is proposed that aviation also be included in the EU ETS. Aviation would then be treated like other EU ETS industries and receive 80% allowances free of charge in 2013 (which percentage would be reduced by equal amounts each year, finally reaching zero in 2020). Shipping may be included at a later stage, when an impact assessment has been concluded.

EU based emission reduction projects

The Proposal provides for the possibility that tradable emission allowances are obtained from emission reduction projects in the EU, provided that there are clear regulations at EU level to prevent "double counting" and that these projects do not entail an excessive administrative burden.

Linking to other emissions trading systems

The EU ETS can be linked to other mandatory emissions trading systems in third countries or administrative entities (e.g. federal regimes). This may be arranged by agreements for the recognition of allowances between the EU ETS and the linked systems.

Use of CERs and ERUs

Based on a 20% emissions reduction scenario (i.e. before a satisfactory global agreement is reached), the Commission proposes to allow operators to use CERs and ERUs only to the extent that the levels of CER/ERU use allowed by Member States for Phase II have not been used up. Furthermore, these credits must stem from project types which were accepted by all Member States in the EU ETS during Phase II. If these conditions are met, Phase III allowances (valid from 2013 onwards) can be obtained in exchange for:

- CERs and ERUs issued during Phase II (these must be exchanged prior to 31 December 2014);
- CERs issued after Phase II from projects established before 2013; and
- CERs issued after Phase II from new projects started from 2013 onwards in Least Developed Countries.

In the event that an international agreement on climate change is delayed, the Commission proposes to allow credits from new projects or other emission reducing activities to be used in accordance with agreements concluded with third countries, but - again - only to the extent that the Phase II levels of CER/ERU have not been used up.

Based on a stricter emissions reduction scenario (i.e. in the context of an international agreement), the limit on the use of CERs/ERUs would automatically be increased up to half of the additional reduction commitment. This means that if the annual cap under the EU ETS were reduced, for example, by a further 200 million tonnes following a global agreement (in order to achieve the more stringent reduction target for overall emissions), the limit on the use of CERs/ERUs would be raised automatically by 100 million credits. Credits additional to those left over from Phase II would then only be accepted from projects in third countries that ratify the international agreement or from additional types of projects approved by the Commission.

Harmonisation

Several of the proposed changes aim at harmonising certain elements of the EU ETS that are currently decided at Member State level.

No more national allocation plans

As the quantity of allowances to be auctioned or allocated free of charge will be determined at EU level, there will be no need for national allocation plans. From 2013 onwards, trading periods would run for eight years. Should the adoption of the Proposal be delayed, the EU ETS Directive will remain in force unamended and Member States will still be required to draw up and submit national allocation plans by June 2011 for the trading period 2013-2017.

Community registry

It is intended that EU allowances issued from January 2013 onwards will be held in a consolidated Community registry. This should simplify the EU ETS and reduce any risks related to the current system of national registries. However, the Proposal does not clarify what will happen with the national registries for CERs and ERUs. In our view, it would be in accordance with the harmonisation objective of the proposal to hold CERs and ERUs in the Community registry as well. This would also simplify the linking between the EU ETS and other emissions trading systems. If CERs and ERUs were indeed to be held at Community level, procedures for the registration of CDM/JI projects and the issuance of the relevant letters of approval would also need to be adopted, to allow emission credits from these projects to be received in the Community registry.

Monitoring and verification

To complement the general EU ETS requirements and avoid varying practices in different Member States, a regulation for monitoring and reporting and a regulation for verification and accreditation is to be adopted. This will allow, among other things, EU-wide accreditation for verifiers.

Areas without changes

The EU ETS will continue to be the EU's main tool for achieving its emission reduction commitments.

Banking

The possibility of carrying forward unsurrendered allowances from one trading period to the next ("banking") is not affected by the Proposal. It will therefore be possible to convert Phase II allowances

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into Phase III allowances (valid from 2013 onwards). In the explanatory memorandum to the Proposal, the Commission confirms that any Phase III allowances resulting from banking "will come on top of the Phase III cap decided in the review". It is not yet clear how banking will operate in the transition from Phase II to Phase III, given the fact that Phase II allowances are held in the national registries and Phase III allowances will be recorded in a consolidated Community registry.

The way forward

The Proposal will need to be adopted through co-decision by the Council and the European Parliament. Preparatory discussions will begin sometime during the next few months and it is expected that a final Directive will not be adopted before the summer of 2009.

Parallel to the Proposal, the other parts of the European Union Climate Action package will be discussed, among which are the Effort-Sharing Proposal, the CCS Proposal and the draft directive on the promotion of renewable energy. The outcome of these discussions may influence the decision-making process and the content of the Proposal.

Contact information

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