

IETA's position paper to the EU ETS Review

EU ETS Review “Building a global carbon market – Report pursuant to Article 30 of the Directive 2003/87/EC” (Communication – COM (2006)676 final), Brussels, 13.11.2006)

Introduction

The objectives and context of the Review

The EU ETS is the key environmental instrument in achieving Member States Kyoto targets. The preparation for phase III will go beyond Kyoto and make a substantial contribution to the “building of a global carbon market”. Emissions trading and reducing emissions is the “pro-growth” strategy for the future as recently underlined by the Stern Review. IETA expects that the final review will lead to adjustments of the Emissions Trading Directive in order to achieve 6 objectives:

- Improve its functioning by increased predictability, simplicity and transparency
- Ensure competitiveness of European industry both within Europe and throughout the world
- Further harmonization of the implementation of the emissions trading directive between Member States
- Extend the scope (e.g. inclusion of other sectors and gases) where cost effective and where there is no interference with other policies and measures.
- Limit the scope (e.g. inclusion of other sectors and gases) by consideration of de minimis provisions based on the lack of cost effectiveness of reporting small emissions quantities, technical feasibility, and where other policies and measures are not effective.
- Provide access to other CDM and JI project credits to ensure emissions reduction in the EU ETS system are cost effective
- Link to other emission trading schemes in third countries by adapting the Linking Directive

A particular challenge of the Review is the uncertainty related to the agreement of a global post-2012 regime. The EU ETS will be therefore reviewed against an international background which is still to be determined. The Review has not yet



specified the level of ambition in terms of the level of the EU ETS total cap. IETA sees that more progress needs to be made in a total EU cap so that adequate national caps delivering real environmental improvement can be identified and agreed. In view of this uncertainty, IETA recommends that Phase III be accompanied by a deepening of the current large industrial emitters scheme rather than a broadening to other smaller source emitters. This approach should be reviewed in the light of linking opportunities to other international schemes.

Keeping the right balance to sustain the functioning of the system

IETA would like to take the opportunity to highlight the fact that this review deals largely with design issues of the existing scheme and does not yet encompass the potential or possibility for the EU ETS to be fundamentally modified

1. The scope of the Directive

The EU ETS is an environmental measure that aims to reduce CO₂ emissions cost-effectively. It does this by creating a traded market in allowances to emit CO₂. Sites emitting large volumes of CO₂ should be included in the scheme on environmental grounds.

The EU ETS was originally limited to only CO₂ and to installations from six[I thought it was 4 sectors] industrial sectors in order to keep the system simple and cost efficient. This section considers the inclusion of other non-industrial sectors and other gases, which will naturally pose a challenge.

Reaching harmonization of the definition of combustion installations and the exclusion of small installations in accordance with previous Commission Guidelines should be a less complex task. Finally, this section will consider the potential inclusion of carbon capture and storage projects and domestic offset projects in the ETS

1.1. Combustion installations

Harmonization in the EU ETS includes the equal treatment of similar installations. As such, IETA supports a common definition of combustion installations and a common threshold for EU ETS inclusion, so as to limit competition distortions amongst member states (MSs) and increase allocation predictability. Whilst most MSs have complied with the European Commission guidelines it will be necessary to address this point in the Directive.



Recommendation:

There has been much progress in overcoming inconsistencies between the MS definitions but there are still problems with respect to consistent implementation of a common definition. The definition determines whether an installation (if not mentioned explicitly) is a participant or not. IETA suggests to use the definition of "combustion plant" set in the Directive on Large Combustion Plants (88/609/EEC as amended by 2001/80/EC) can be used: "Installation: any technical apparatus with a rated thermal input exceeding 20 MW (except hazardous or municipal waste installations) in which fuels are oxidized.

IETA would also recommend that the decisions/changes should be incorporated in the Directive. In addition, industry expertise should provide input on definitions.

1.2. Other sectors and gases

Sectors in which abatement opportunities are real, sizeable and well understood have the potential to be covered under the existing structure of the EU ETS. Increasing abatement options through the inclusion of more sectors will, when implemented properly, increase market liquidity and effectiveness. At the same time it could lead to further distributional and competitiveness impacts and may increase complexity and administrative costs.

According to the Kyoto Protocol there are five GHG gases other than CO₂. The European Commission Review suggests including more gases by considering, for example, the following gases/sectors not yet included in the EU ETS:

- CO₂ from the production of petrochemicals
- CO₂ and N₂O from the production of ammonia
- Production of fertilizers other than nitric and adipic acid
- CO₂ and PFCs from the production of aluminium
- CH₄ (methane) from coal mines
- (Aviation which is not part of the Review but a candidate for inclusion as early as 2011)

IETA believes that the goal is to include as many gases and sectors as possible in keeping with the guidelines/criteria hereunder:

1. Gases: The inclusion of other non-CO₂ gases should consider the effectiveness of existing and future planned mitigation measures in those sectors emitting those gases and where possible should be coordinated across Member States. For example, as France and The Netherlands have already opted to recommend inclusion of N₂O from Adipic acid plants via Article 24 of the Directive it would seem sensible to investigate extending this across the EU. At the same time, discussions at ECCP seem to point towards the fact that non-CO₂ gases, for example, CH₄ from coalmines, would be better addressed via project credits,



and considered planned or existing reduction measures on the other non-CO₂ gases to be sufficient.

2. Sectors: Given the current core approach to compliance (based on large, static installations), the inclusion of other sectors should be subject to the cost of effective monitoring and compliance not proving prohibitive when compared to the effectiveness of other mitigation measures (e.g., direct regulation, taxes etc). This will allow the expansion of the scheme to some relatively well-defined sectors (e.g., the European Commission guidance document¹ dated December 2005 recommended that ethylene crackers be included under the current definition of combustion installations for Phase II).

However, the inclusion of other CO₂ sub-sectors of the chemical sector will prove more complex and will require more work to define appropriate boundaries for candidate sectors for inclusion in Annex I of the Directive. (As noted above, we would also recommend that the possibility of including the transport, domestic and commercial sectors - e.g. via upstream approaches - be investigated furthering line with linking opportunities.)

3. Competitiveness: The impact of including a sector on EU companies' ability to compete with companies outside of the EU is an issue that needs to be recognized and addressed, including various impacts that might be incurred through differing allocation methods, for those business sectors heavily exposed to global competition.

4. "Make or buy": In other sectors, the "make (reducing) or buy (purchase of allowances)" issue is fundamental to whether or not it is economic to include these sectors within the ETS. Under the current compliance framework, the benefits of emissions trading rely on the installation having some means to mitigate emissions via:

Fuel switching;

Energy Efficiency or emission mitigation projects;

Changing the mode of operation.

The current focus of the ETS on industrial emissions fits well with this model. Installation can potentially switch fuels (coal or gas for power generation), can implement energy efficiency projects and can even change the mode of operation of the facility (running using a different crude oil type). The role of the ETS is to direct capital within the economy to the point at which it can be most

¹ Communication from the Commission (COM/2005) 703 final, *Further guidance on allocation plans for the 2008-2012 trading period of the EU ETS*



effectively used to mitigate emissions. The capital is used to invest in facilities and mitigate emissions through projects.

Although the road transport sector generally challenges the model above given the reported price inelasticity of individual motorists to fuel prices and taxes, fleet transport may nevertheless offer a better fit for the “make or buy” model given the potential to reduce emissions via wholesale operational changes, fuel switching (i.e.: to LPG) and purchasing of high efficiency vehicles.

In the case of aviation, although efficiency can be improved gradually by fleet turnover and the carrier (at present) has little influence over the fuel used, the carrier, as the allowance holder, can still adjust the mode of operation through schedules, types of plane used on different routes and cooperation with airport authorities in ground operations and taxiing.

Although the core of the EU ETS should remain based on this make-or-buy model, as noted above, this should not necessarily be the only test for the inclusion of other sectors and the.

Recommendation:

IETA recommends that the EU ETS should be extended to include other industrial sectors and gases but with due consideration to a set of conditions defined hereunder.

1. Feasibility of monitoring, reporting and verification of emissions.
2. Cost effectiveness (de minimis definition required).
3. Suitability of other policies and measures to make equivalent emissions reductions (No double regulation)
4. The “make or buy” rule (as explained above) should be the primary means to identify suitable sectors for inclusion
5. The potential to expand the scheme via other approaches – including upstream compliance – should be investigated further.
6. Competitiveness: The impact of including a sector on EU companies' ability to compete with companies outside of the EU is an issue that needs to be recognized and addressed, including various impacts that might be incurred through differing allocation methods, for those business sectors heavily exposed to global competition. However, it must also be noted that competitiveness should also be considered in the context of comparing the impacts of ET with other alternative instruments that could be used to address climate change.



1.3. Small installations

There is limited emission reduction contribution made by EU ETS small emitters. However their contribution to a member states' overall carbon position is important.

According to Worrel and Woosen, setting a de minimis level of 10,000t CO₂ per annum would remove some 32% of EU ETS participants while losing only 1% of emissions covered. Excluding installations of less than 25,000tCO₂ per annum would reduce the covered installations by 55% while reducing covered emissions by 2.4%.

For reasons of efficiency, IETA supports the exclusion of small installations from the scheme as it is currently framed, provided that appropriate policies are developed outside of the scheme to effectively limit emissions from these sources.

Finally, while we appreciate the need to keep a tight focus on the scope of the Review, we must remember that this Review is likely to define the key parameters of the scheme until at least 2017 and beyond.

Over this horizon, it seems somewhat premature to rule out expanding the scheme to other sectors characterized by small "installations" such as road transport, domestic and commercial sectors. Over this time horizon, a more flexible approach to monitoring and compliance and/or technological advances could make it both feasible and economic to expand the scheme to new sectors and smaller emissions sources and it would seem worthwhile to ensure that we begin to investigate these possibilities and retain the flexibility to act on them as appropriate.

Recommendation:

IETA supports, in conjunction with other cap based regulation, the use of a de minimis level per installation in order to reduce the costs and administrative burden on smaller installations.

Those installations opted out of the system shall be governed by alternative legislation designed to limit their emissions to an equivalent degree as under the ETS. This legislation shall be in place before an installation can be opted out. The threshold for opting-out should be harmonized at EU level and based on emission volumes. The NL threshold of 25kt CO₂ per annum is considered appropriate. In any period, once this threshold is exceeded in any single year, the company remains within the ETS for that period. The test for installations whether they exceed 25kt CO₂ can be done through monitoring and reporting of emissions, without verification, to reduce costs.



Another possible alternative would be to revive the opt-out provisions from the first period for small installations with very clear definitions.

Companies, which have invested heavily to comply with the current regulation, should be allowed to join the scheme on a voluntary basis even if they do not reach the threshold. If small installations remain in the scheme it may be appropriate to introduce simplified monitoring and reporting guidelines in order to reduce the administrative costs while still reaping the benefits of a broadly applicable system.

The Review should initiate an investigation into how a more flexible approach to compliance (e.g., a combination of installation and upstream approaches) and/or technology could be used to limit the associated monitoring and compliance overheads associated with extending the ETS to cover domestic, commercial and transport emissions. The Review should also ensure that there is sufficient flexibility in the rules to allow these sectors to be included during the course of Phase 3 and beyond.

1.4. Unilateral inclusion of additional activities and gases

Some member states have expressed interest in including other sectors and gases within their own jurisdictions. IETA supports the expansion of the scheme as long as such inclusions are efficient and subject to the same stringent environmental and reporting requirements as the rest of the scheme. However, due to the potential for impact on long-term asset management, it is recommended that a significant lead-time be given to allow companies to plan for their installations inclusion. Furthermore, the inclusion of a sector mid-way through a trading period would cause market distortions and should be discouraged.

Recommendation:

IETA supports the expansion of the EU ETS and recommends that Member States should be authorized to unilaterally include new sectors and gases as long as EU Monitoring and Reporting Guidelines are followed and the six minimum criteria described under section 1.3 are fulfilled (see under Recommendation). However, a harmonized opt in is preferable to avoid distortion of competition. Also further simplification of the-opt in would help continue to make the process appealing. Harmonized opt in is critical since there would not be any MRG at EU level for these opt in installations and the MRG details would be determined by the country that opts the installation with potential for variation across same installations but in different Member States.



1.5. Carbon capture and storage

Carbon capture and storage (CCS) in the EU and EEA can play a decisive role in meeting recently announced emission reduction targets² for 2020 and beyond. To improve the economics of CCS technologies and to further document the containment capability of CO₂ in different geological formations, any private sector demonstration project will initially require financial support in addition to EU ETS benefits. Whilst only crediting CO₂ reductions in the EU ETS is necessary and helpful, it will not be sufficient to enable CCS to make early contributions to these priority EU emissions reduction objectives.

A long-term policy framework and confidence that a carbon market will be sustained into the medium and longer terms are vital to encourage investment in CCS activities.

Recommendation:

For Phase III IETA recommends that the EU ETS Directive³ be specifically amended to acknowledge the benefit of carbon capture and storage activities. This is explicitly different than the current application for CCS in Phase II, whereas the entire CCS chain (capture, transport and storage activities) must be opted in – as a single installation - to the EU ETS under Article 24 of the EU ETS Directive. The revision should be clear and transparent, taking into account the conditions and special characteristics of CCS activities, and to be flexible enough to accommodate a variety of business models. To provide regulatory predictability for business, it is important that EU CCS framework regulations and an amendment to the EU ETS Directive are done in parallel.

Accounting for CO₂ in CCS activities can be done one of two ways:

- CO₂ stored in an approved geological formation is counted as non-emitted CO₂ by the emitting installation
- CO₂ stored in an approved geological formation is eligible for a tradable credit under the EU ETS

The approval of capturing, transporting, injection and storage activities should be in the hands of Member States. Not all activities along the CCS chain need to be defined as separate EU ETS installations. Furthermore, permitting the entire CCS chain as a single installation will likely prove to be unworkable in many

² Sir N. Stern, Review on the Economics of Climate Change, H.M.Treasury, UK, Oct., 2006

³ EU Emissions Trading Directive 2003/87/EC



situations. IETA recommends a flexible approach designed to allow the most appropriate contractual model in each circumstance.

Monitoring plans for CO₂ storage sites should be developed on a case-by-case basis, reflecting local conditions to manage potential risks for each specific CCS application. Monitoring should continue to evolve with improved technologies, new information, and ongoing risk management.

Extending existing EU regulation, administered by Member States, would cover the environmental integrity of CO₂ storage and provide an interface with local stakeholders and public interest groups. The benefits of storing CO₂ permanently - balanced alongside other public interests - should rest with the designated authorities in Member States. Storage site approval and conditions for storing CO₂ in geological formations - for the purpose of climate change mitigation - should be aligned with the IPCC Guidelines⁴ on CCS.

With the appropriate regulatory framework, IETA regards it unnecessary, overly complicated and time consuming to establish an additional centralised layer of approval at the Community Level. It should be sufficient to use the EU's existing environmental compliance mechanisms if the EC or a Member State wants to challenge the approval of a CO₂ storage site proposed by another Member State.

EU framework regulations should be developed to foster:

- Adequate harmonization between the licensing and controlling practice on CO₂. In particular, storage regulation covering permanence and principles for long-term liability of possible atmospheric release must form a level playing field.

- Common principles in the Member States to assure that transparent and comprehensive Environmental, Safety and Health Impact Assessment has been performed for approving CO₂ transport and storage, This would include appropriate consultation with stakeholders as well as other States to submit recommendations.

- Common principles for regulation and agreements between the effected Member States if the geological storage site crosses national borders.

- Assurance that the Member States' regulations and practice of approving and controlling CO₂ transport and storage are aligned with the IPCC 2006 Guidelines⁵

IETA is working on a more detailed proposal for an EU regulatory framework for recognizing CCS.

⁴ IPCC 2006 Guidelines for National Greenhouse Gas Inventories, Volume 2 Chap. 5.

⁵ *ibid.*



1.6. Emission reduction projects within the Community

Domestic offset projects are similar to project mechanisms in the Kyoto Protocol, used within the home country reduce emissions in the non-trading sector. A number of programs exist or are being developed around the world that allow for the generation of domestic offsets (e.g. US RGGI, New South Wales GGAS, Canadian domestic offset program, New Zealand Projects for Reduced Emissions).

In those sectors that are not in the EU ETS, such as agriculture, waste, housing and transportation, reductions can be generated and thus promote GHG emission reducing.

Current information on the use of domestic projects is limited. An example of domestic projects is the "Projets Domestiques" program currently under implementation by the French Government. The French Government is developing a domestic offset project scheme, based on JI Track I. The conditions for project eligibility are: i) impact on the national GHG inventory, ii) additionality with existing policies and measures, iii) project participants must include a foreign partner. Financial intermediaries offer financial and administrative help with setting up a project, which may be costly for individual project developers.

However, the efficiency of using such a system to regulate emissions should be carefully assessed and drawbacks such as project costs and uncertainties in terms of delivery of credits considered.

It is important that national inventories record these projects consistently.

Recommendation:

IETA recommends the incorporation of domestic offset projects into the third phase of the EU ETS under the condition that there is no double counting of emission reductions between offsets and EU allowances. It is essential to provide for a consistent M&R system. Environmental additionality and interaction with other policies and measures are a critical element.

The credits issued by the domestic project program should be ERUs or should have a similar status as ERUs, so as to i) provide a strong price incentive to project developers and ii) raise interest from the industry sector in developing (or investing in) projects.



Offsets are more complex than ET and will always be, but after years of CDM/JI they are relatively well understood and the decisions are entirely political.

2. Robust compliance and enforcement

2.1. Regulation versus Directive

At present, member states have different and diverse approaches to compliance and enforcement. To ensure the integrity of the scheme, it is necessary to regulate that a verified tonne of carbon is identical throughout the EU ETS. For this purpose, a regulation directly applicable in MSs has an indisputable advantage over a directive, which has led to diverse approaches. To this effect, a balance needs to be kept between high standards and cost-effective solutions.

Recommendation:

IETA encourages the Commission to use all the tools in its possession to require individual Member States to follow the Directive in terms of Monitoring, Reporting and Verification (MRV) requirements, and seek that Member States harmonize their national and sub-national verification requirements in line with this Directive.

2.2. Proposal on verification (accreditation, process)

The current procedures for accreditation are different from MS to MS and even within MSs. This has resulted in a large diversity in the overall MRV process within the system. Notable differences can be observed in the qualification/accreditation of the verifiers (personal or company specific), scope of the verification (reporting only on emission or full scope of the MRV) as well as the handling of non-compliances. From workshops that have been held jointly by IETA and the Commission, the basic outcome has been that both industry and MS are seeking for a larger level of transparency and understanding of overall requirements. A general consensus appears to be present that harmonization of the MRV will enhance the overall performance of the EU ETS as well as lead to a general enhancement of quality and reduction of costs. However, the current tools at hand are insufficient to bring the level of harmonization desired by the industry.

New methods of accreditation should therefore be considered in order to speed up the process as well as increase the integrity of the verification system. Changes to the current system should include mutual recognition of verifiers accredited in other MSs, central accreditation and other existing methods developed by the European Co-operation for Accreditation (EA).



Recommendation:

IETA recommends that the Commission work towards a centralized, professional accreditation system that is robust, transparent and uniform in its approach. The rules and interpretation should be governed by a central body but executed by either the central body and/or local accreditation bodies. Whilst the governance by a central body will provide a harmonized approach through the EU ETS and eliminate duplications, the ability to undertake the work through local accreditation bodies will provide the opportunity to operate under local, specific regulations as well as access (low costs) for small and medium size verification companies operating within a local environment.

In the near term future, IETA recommends that the Commission explore the options of a common accreditation which will lead to solutions that decrease the overall cost to the system, as well as provides credible and consistent accreditation across all EU Member States. In this respect, IETA continues to support activities under the European Co-operation for Accreditation Bodies (EA) and their development and maintenance of the EA/06, and encourages the Commission to continue to be an active player in these activities.

2.3 Additional compliance provision

In the original guidelines for MRV, the commission provided no guidance on its expectations on the manner in which verification would take place. The first version of the MRV Guidelines has however lead to general confusion and varying interpretation by each MS, Industry and Verifier. Following the adoption of the second version of the MRV, some of the confusion has been taken away. Nevertheless there is still ambiguity. Additional guidance is required on some specific governance elements of the verification process, such as: scope of verification site visits, non-compliances and the consequent enforcement of sanctions, late or non-delivery of emission reports, etc.

Recommendation:

Site visits:

IETA recognizes the fact that annual site visits to all locations may not be required in all cases. To give confidence to users that reporting is reliable, IETA recommends that site visits continue to be a significant feature of the scheme. It is for the verifier to determine whether a site visit is required, based on his/her strategic analysis of the installation. In his/her assessment, the verifier may consider the following exceptions: small, remote and/or non-emitting installations.



If no agreement on the need for a particular site visit can be reached between the operator and the verifier, the competent authority will make a final ruling on whether - for this particular verification - a site visit is required or not. Verification statements shall clearly state whether a site visit has not occurred.

As part of EU ETS "*Article 21 - Reporting by Member States*" Member States shall report to the EC all cases where no site visit has occurred.

Monitoring and Reporting Guidelines (MRG) and Non-Conformity:

The current revisions of the MRG have significantly clarified the requirements for installations and verifiers. Section 10.4 of Annex I of the MRG 2008 requires that the verification report (external) include material non-conformities and material misstatements. Non-material non-conformities and non-material misstatements may be reported in the verification report or a management letter. Further text in the same section requires that Member States shall ensure that operators address non-conformities and misstatements.

IETA recommends that:

- Follow-up of non-conformities and misstatements be the responsibility of competent authorities and that verifiers not be required to follow these up in future verifications.
- The Commission provides further guidance on how Member States should address these non-conformities and to what extent these will result in an overall material non-conformity by the installation on its annual verified emissions.

Scope of the verification:

The verification scope has varied across the EU. Resultantly in some member states, verification has been restricted solely to data, without checking compliance requirements in the Directive and MRG. IETA recommends that, for Phase III, the EC makes clear that verification scope will encompass:

- Compliance with the approved Monitoring Plan
- Whether the data has been derived based on requirements laid down in an agreed Monitoring Plan
- Whether based on reasonable assurance and a 5% or 2% materiality, as applicable to the installation size, the data is true and fair.



Late submissions of verified emission reports:

The installation has the responsibility to provide complete and timely information to the verifier in order to allow verification to be completed on time.

Errors in verified emission reports:

The verifier cannot be held liable for a deliberate misrepresentation by the installation.

2.4. Registries

As the lynchpin of all Emissions Trading Schemes, the registries systems must function simply and flawlessly to ensure the integrity of transfers. Without this, the EU ETS will flounder and fail. This section looks at the current situation with the EU ETS registries system and considers some of the possible future developments.

2.4.1. Current Experience with the Registries/Solutions to the Registries in the Short Term

The working relationship between National Registries (NRs), the ITL and CITL is very complex and depends on many factors, including the outcome of international negotiations. In order to envisage possible future challenges and drawbacks, IETA would like to bring attention to issues that have been plotted during Phase I that could also significantly impact the functioning of the EU ETS in Phase III if they subsist.

The registries have provided a high level of service over the past two years. However, some areas of improvement have inevitably arisen which center on these three issues:

1. Connection with the CITL: Whilst generally solid, there have been issues around the reliability of this connection. A CITL outage on a major delivery day would cause contractual chaos and could lead to counter parties trying to renege on economically unattractive contracts, since CITL outage and its contractual results are not uniformly defined within the contracts traded. This, in turn, would lead to a breakdown of the delivery and redelivery chain on the day, calling the efficacy of the system into question.



2. Transfers stuck at status “proposed”: A number of registry users have had problems with transfers getting stuck at status “proposed”. During such time, that volume cannot be used for other purposes and the recipient does not receive it. This has been a common problem over the last two years.
3. “Cancelled” transfers still being counted in the registry total: Often, when transfers get cancelled, it is usually because the CITL has gone down, ensuing a transfer that times itself out after 24 hours. Throughout this occurrence, the registry balance total still remains debited/credited accordingly. This has been a problem for some registries based on their design.

Recommendation:

The issues listed above need to be addressed on an urgent basis.

2.4.2 A Single European Registry

From the outset, a single registry has the potential to reduce the time for any decision-making processes as well as to introduce increased efficiencies in the system. Currently, NRs possess the ability to customize each registry in terms of what kind of CER can be held inside. This would not be possible under a single European registry system.

However, in the current situation, if one registry goes down or terminally malfunctions, the others keep functioning and maintain the integrity of the system. Currently, some institutions keep functioning registry accounts in more than one country as a safety valve for just such a reason. In the case of a single registry system, this insurance against failure would not be possible.

Furthermore, emissions reporting and administrative follow-up of monitoring plans and emission permits will be a mammoth task to fulfill for all 27 countries in the EU. Systems to deal with these issues are additional to the existing NRs and the EC will have to play an important role in supporting the harmonization of work in emission data reporting through automating verification work and stimulating workflow automation.

Some MSs are already considering developing their own specific functionalities above the basic “engine” of the community registry, hence allowing them flexibility to take different approaches in organizing and implementing the EU ETS Directive.



The registries support help line has been used extensively over the last 2 years. The helpdesk for a single European registry would have to support 27 countries, integrating all the communication and language difficulties that entails.

Also, since countries have differing policies regarding the acceptance of CERs and ERUs, a single European Registry would effectively need to be internally partitioned along the different rules for acceptance of CERs. Alternatively, a single approach to the use of CERs and ERUs by MSs would have to be adopted.

Depending on the future negotiations regarding a post-2012 extension of the Kyoto Protocol, practical considerations will also arise regarding how MSs comply with their Commitment Period Reserve. Will its credits in the EC registry be measured along with its credits in the respective MS national registry?

If the intention is to have a single registry and no national registries, then a vital question arises with respect to the insolvency treatment of a credit that may be held in the EC registry. If an installation or private entity becomes insolvent, how does the registry administrator deal with the credits that are sitting in the insolvent entities account? Are they available for creditors? Does the registry administrator recognize the prior ranking rights of secured creditors over those of an insolvency officer etc.?

Finally, a single European Registry could be subject to standard EU decision-making processes. Since this requires consensus, changes to the registry system may be hindered by the veto right of any of the Member States. Taking this into account, a single European Registry may put forth political problems in the future. This is an issue that needs to be explored deeper.

2.4.3 A Single European connection to the ITL

This option is similar to a Single European Registry and has some similar issues. Under the current Registries Regulation, in order to transfer EUAs or Kyoto Units within the European scheme, a transfer will have to be validated through BOTH the CITL and the ITL. The interaction between the two systems is currently untested and hence a central issue to the reliability of the system. Some notable CITL outages last year along with the introduction of the ITL will possibly make this type of issue occur more frequently.

A number of practical issues need to be considered in such a structure, in particular in relation to the allocation of risk. In the context of a private entity CER transfer between a Member State national registry and another Annex B Party registry (that is not a Member State), if the private entity does all it can to achieve the transfer by communicating to the CITL but there is an issue with the ITL



connection to the Annex B Party registry, who will take responsibility for that failed delivery?

Similarly, for a transfer from an Annex B Party registry to a Member State registry, if the private Annex B Party entity has instructed the ITL to make the transfer but there is a problem with the CITL, then who will take responsibility for that failure to deliver? The risk allocation will have to lie on one side or the other. Under the current structure both parties instruct the ITL and therefore the issue does not arise.

To assure that proper checks and balances are in place, and to be managing risks easier, these tasks/obligations should be divided amongst the EC and the MSs, leaving the management of the CITL within the European Community.

Recommendation:

IETA finds that current developments in the structure and functioning of the registry system could have long-term effects and implications. In order to address the long-term issues, solutions to present day concerns need to be evaluated and acted upon. With this in mind, IETA has pointed out some of the key topics to be addressed in the registry system. Long-term issues between registries are complicated to foresee, as the CITL and ITL are not currently interlocked.

Above all, the structure and function of the registries system should provide for accurate and timely delivery of products traded. The terms and conditions for trades will need to be well defined in contractual agreements. The system should embody dependable and fluid interactions. The parties involved in each exchange of goods should have clear expectations of the current volumes and products involved in the interaction. They should also understand the impact each trade will have to their own registry.

IETA views the idea of a single European registry to be an ambitious consideration, but currently the negative possible impacts of a single registry outweigh the probable positive benefits. Overall, the support and political demands brought upon by a single registry might be unsustainable at this moment. The situation may be better evaluated in a forthcoming setting, under new rules.

In the long term, the European Commission should evaluate what is necessary to maintain what is perceived as being important - its desired independence of the EU ETS registry system from the UNFCCC decision-making process in order to ensure that a business level EU trading scheme does not become de facto regulated by the UNFCCC intergovernmental process, which requires consensus and is not agile or accountable in the same way. In addition, the EU ETS should minimize dependence on post-2012 discussions.



IETA recommends that the technical standards for information exchanges within the EU ETS registry systems be modified according to the Commission's standards, independently from COP decisions or UNFCCC expectations. The requirements and process to be followed in order to facilitate these needs should be determined and acted upon within a reasonable timeframe. IETA sees the benefits in the EU ETS existing in its own right, as a system independent of the UNFCCC.

Consultative meetings between the UNFCCC and administrators could be made public. This would enhance transparency in terms of the development of the registry system, therefore benefiting future cooperative efforts.

3. Further harmonisation and increased predictability

3.1 Setting the cap

New technologies and their diffusion will depend to a high degree on the predictability of there being a future price of carbon high enough to sustain them economically. The price of carbon, under the current regime, is a function of the scarcity of allowances in the market, determined through a long-term EU cap. Lack of predictability in the expected stringency in the market will impact on the level of incentives given to the market.

The options being explored are for a) one EU ETS-wide cap or b) by MS. In option b) the EC would like to get further feedback on deciding up front in the Directive or through NAPs.

Recommendation:

In general, IETA would prefer to have a cap and an allocation system that provides for increased harmonization, reduces distortion of competition and increases predictability. The consequences and feasibility of any approach needs to also be considered.

In this sense, a EU ETS-wide cap provides the advantages of a more harmonized and unified approach but will be politically difficult to implement. Overall preference is for a EU ETS-wide cap, which helps to determine a level of ambition, gives early signals and establishes a level of scarcity in the marketplace. Benchmarking could be done for those sectors that lend themselves to such approach. For those installations that are not covered by the EU cap, the MS could do the allocations themselves.



In terms of MSs setting the cap up front, in the Directive or through NAPs, predictability and ensuring that information is timely are imperative. Therefore, setting caps in the Directive would prove advantageous.

3.2. Predictability

In order to provide for longer-term investment horizons, carbon pricing needs to become embedded into capital asset planning, since research and development, breakeven/payback periods and relevant forecasting can take several years to realize. Certainty should be extended beyond the current 5-year period. This certainty can come in several forms such as long term EU targets, assurance that the ETS will continue to operate or rolling allocation periods (ie: continual certainty on allocation x number of years into the future) without the need for longer allocation periods. In the long-term, investment in new and low-carbon technologies will not be possible without certainty about the targets and potential returns under the ETS.

The EC would also like comments on the desirability, in order to increase predictability, on whether a cap should be set for long periods, or a formula should be defined with periodic allocations at the installation levels.

Recommendation:

IETA recommends a 10-year allocation, potentially rolling allocations as long as this does not become a yearly process. This will allow a permanent horizon for investment but will ensure that changes to the scheme can be implemented regularly with a standard lead-time of 10 years. The next allocation period should be determined 5 years in advance so that investments can be made over a period of greater certainty.

3.3. Allocation of allowances to sectors and installations

It is important that the advantages of establishing emissions trading, which harnesses market forces to deliver emissions reductions at the lowest possible costs, are not undermined by the allocation methodology used. This can easily occur if governments and regulators do not recognise the essential benefits and operational aspects of the EU ETS.

Regulators implementing an emissions trading system generally consider three allocation options: grandfathering, benchmarking and auctioning. It will be important to better understand the effectiveness of these three approaches in the context of the following principles that IETA has put forth:



1. Purpose of allocation is to distribute carbon scarcity to the economy, as equitably, predictably and efficiently as possible;
2. Institution of property rights to carbon creates fungible value, but no new wealth;
3. Allocation process itself should not pre-determine market outcomes, i.e. it does not produce 'winners' and 'losers'.

Even though differing allocation approaches might be taken by each industry, IETA believes in keeping a high degree of harmonization amongst these approaches. An overall cap on auctioning or a minimum auction percentage as part of the cap would be two possible ways to enact this. Without a cap on auctioning, Member States would be free to use auctioning up to 100% in the third allocation period.

Recommendation:

IETA recommends a harmonised approach on allocation. There is a need to set a cap on purchased allocation in order to avoid distortions in cross-border competition.

Harmonisation of allocation methodologies and their consistent application will make the system more efficient and transparent. Whilst grandfathering is increasingly phased out, auctioning and benchmarking become more widespread. Benchmarking could be done for those sectors that lend themselves to such approach.

Initially some sectors like aviation and cement may more likely apply benchmarking than others, such as the chemical industry.

3.4. Auctioning

Member States can auction up to 10% of allowances during the second allocation period. Current NAPs for Phase II do not all make full use of this potential and only 10 Member States (MS) envisage auctioning; Germany setting the highest level so far (8.8%). The other Member States include Belgium, Hungary, Ireland, Belgium, Lithuania, Luxembourg, the Netherlands, Poland and the UK.

In the post 2012 scenario, the European Commission envisages extending the scope to allow for the wider use of auctioning.

One elemental aspect of auctioning is that it likely implies a capital transfer. This means:



- Participants need a good understanding of the use of revenue from auctioning. Auctioning without recycling will be perceived as a tax.
- As an initial allocation mechanism it runs the risk of significantly increasing the cost to industry. Even if auction proceeds are recycled there is a delay, which has to be financed by installations via market prices.
- Sectors which are exposed to competition from outside the system need to be dealt with in a different way to those who can pass through their costs.

No one allocation methodology is optimal but auctioning requires specific consideration to equity concerns, capital transfer and rent distribution.

Auctioning has advantages and disadvantages. Some advantages:

- Simplicity – IF designed right
- It guarantees equal access to allowances
- It engages emitters in the ETS
- Transparency
- It aligns with 'polluter pays principle'
- It addresses concerns over 'windfall' profits
- It removes "politics" from allocation

The disadvantages are:

- Auctioning appears as a tax unless costs passed on
- Payment up front places significant financial burden on companies
- It removes funds for investment from business
- Is government better at investment decisions ?
- Complexity of organising a harmonised auction at EU level
- It could be vulnerable to
 - Manipulation and speculation
 - Price spikes and collapses
- Auctioning also has a potentially negative impact on security of energy supply and on national industrial policies due to competition between sectors for allowances.

Recommendation:

IETA is open to any form of distribution of allowances as long as the allocation process distributes carbon scarcity to the economy, as equitably, predictably and efficiently as possible and it does not predetermine market outcomes.

Auctioning requires specific attention, in particular with respect to fairness between sectors and their ability to pass on costs to the end consumer.



If the EU (at least partially) prefers auctioning, it should be made as open, transparent and simple as possible. It must be introduced gradually, taking into account the level of development, especially scope, of the global GHG markets and concerns over competition, and would need to be harmonised with rules governing the manner and frequency with which auctions are held. In this context, it should be periodic, timetabled and coordinated, causing no large distributional effects.

If auctioning is implemented, the bulk of the proceeds must be recycled. Recycling of revenues should not be used to introduce new market distortions, but should be used to remove existing ones. It is therefore important to address options on how revenues from auctioning can be re-invested to support emission reduction goals.

Auctioning should be designed taking into account the need for future new investment and in support of long-term regulatory predictability.

3.5 New entrants and closures

All EU Member States have provisions. In principle, closing old, inefficient factories is encouraged as it makes space for new entrants. Treatment of these elements in the current NAPs is inconsistent, creating distortion. In the EU ETS Phase I, only two Member States allow installations to keep allowances in the event of installation closure. Most Member States have made provisions for a New Entrants Reserve (NER) and some have introduced so-called transfer rules, which allow companies to transfer allowances from an old installation to a new one.

IETA believes that in a post 2012 scenario there should be further harmonisation on how MSs treat New Entrants. In principle, the allocation rules for new entrants should not lead to competitive distortions within the markets through the use of emissions trading. To ensure that CO₂ is abated at least costs, entry and exit into these markets should not be prevented or stimulated by allocation rules, as this hinders the closure of inefficient installations and the roll out of future abatement opportunities currently under rapid research and development.

Conversely, companies closing their installations should be allowed to pass on their excess allowances to new, more efficient plants in order to help finance them. This transfer will allow companies to switch towards more efficient installations whilst closing inefficient ones. Policy needs to be in place to encourage progression towards efficient technology. When old technology is



phased out, credits might then become available which would henceforth be used to incentives highly efficient plants. NER allocations should be based on high-level benchmarking/efficiency standards.

Recommendation:

No special rules should apply for closure of installations. Companies closing their installations should be allowed to keep their allowances during the time of the allocation period provided that they transfer them to new upgraded installations within the same company.

For new entrants, if the method of allocation is auctioning, then no special procedures are needed. For free allocation, there is a need for a NER but allowances should be allocated based on high-performance benchmarks. Also, clear definitions should be put in place to define how long it takes before an installation becomes an incumbent.

Finally, different provisions for NER in different MSs can cause distortions in competition. There will be a competitive advantage in investing in those MSs who have a substantial NER as opposed to MSs that do not foresee them.

4. Linking with emissions trading schemes of third countries

A price for carbon is an important element in having the tools to combat climate change. Moving to a global price, and a global GHG market, is one of IETA's fundamental goals. This was initially envisaged to happen through Article 17 of the Kyoto Protocol, which allows for international trading between Parties.

IETA is hopeful that the UNFCCC process will continue to progress, but the world of emissions trading is moving rapidly to a situation where a number of Domestic Emission Trading Schemes (DETS) at the corporate level are emerging, each with their own characteristics and sometimes reflective of national or regional approaches to circumstances. While the EU ETS is the most advanced, there has been explicit interest in linking DETS; efforts to explore how that can be accomplished have taken place. IETA has investigated conditions and mechanisms for linking, starting with an initial paper in 2002, which was commissioned jointly with the IEA and EPRI.

The conclusion that was reached then, and is still valid now, that linking of the EU ETS with other DETS is a process that will require political will, but is one that



can be accomplished with a relatively limited number of 'must have' components that will need harmonization. The importance of achieving this cannot be minimized.

4.1 Rationale for Linking

Emissions trading delivers economic efficiency by discovering and exploiting differential costs of abatement. Linking to create a larger carbon market improves the efficiency of emissions trading for two fundamental reasons. Firstly, a larger market is inherently more efficient, liquid, and competitive. Secondly, a larger market provides a broader pool and greater variety of abatement costs in which to discover opportunities for low-cost abatement.

Globally, linking allows more GHG abatement to occur with the same level of social resources, or conversely the increased efficiency can reduce the social costs of a given carbon constraint. As we contemplate more ambitious targets for 2020 reduction than those that informed the Kyoto Protocol, it becomes essential to make lowest cost a key concern.

It has been argued that simple price harmonization will reduce competitive pressures, and that direct linking of emissions trading systems is not necessary. However, this fails on two counts. Firstly, the potential cost savings from market efficiency and size will not be as fully realized. Secondly, it is difficult to envision how this price harmonization would actually be maintained. The simplest and most effective mechanism to ensure price harmonization is a single market.

For corporations seeking to compete across global markets, managing their compliance portfolio in a similar manner will allow for additional efficiencies, while substantially reducing risk. A broader market linked across jurisdictions provides greater certainty by pooling regulatory risk

Expanding the market around the EU ETS will expand potential for gains from trade, reducing compliance costs for European emitters. However, there are critical possibilities that extend from the EU ETS as the largest existing market. The EU ETS has the opportunity to be the nucleus of a global carbon market, providing the potential for first mover advantage. This advantage may provide considerable for European industry. While the EU might expect to see a flow of capital outward through linking to economies with a lower initial cost for carbon, this would be compensated by an expanded market for European low emission goods and technologies.

4.2 Conditions and Limitations

Linking requires a careful assessment of the two systems for structural compatibility along three dimensions: technical, environmental, and



competitive/economic. In considering linking, it is important to remember that the more extensive the link, the greater degree of inherent reciprocal acceptance of design elements. Some elements therefore preclude or significantly complicate linking.

i. Technical

This dimension is essentially one of institutional compatibility, or the effects of differences in the definition of units and standards. In this context a ton is a ton is a critical element and MRV standards are critical for linking.

Differing registry standards or points of regulation may significantly complicate linking, even where both alternatives are valid approaches. Party status in the Kyoto Protocol is a critical technical distinction between domestic emissions trading systems. Direct linking in the first commitment period of the Kyoto Protocol can in practical terms only occur between Parties to the Protocol.

ii. Environmental

Stringency and type of targets, penalties, offsets standards, and borrowing are all elements which may produce incompatibilities that in turn complicate or limit linking. Where linking two systems may result in a net increase in overall emissions, the policy objective of at least the more stringent system is undermined, and linking may be unacceptable. This is clearly the case for a price cap/safety valve structure, and is a concern for systems using intensity targets as well.

iii. Competitive/Economic

Significantly, different sectoral coverage across two systems is likely to accentuate competitive issues for the sectors in question. This will be the case unless the other policy and measures applied reasonably approximate dynamic carbon pricing, which in practical terms is difficult to envision with a static policy.

iv. Possible linking partners

- a. RGGI – The Regional Greenhouse Gas Initiative
- b. Canada (proposed April 2007)
- c. Australia NETS (Proposed December 2006)
- d. California (conceptual, MAC report, June 2007)
- e. Lieberman-McCain (Proposed US Federal)



- f. Bingaman, (Proposed US Federal)

4.3 Mechanisms

In a technical sense, the more design elements shared between two systems, the easier it is to link them formally through common acceptance of allowances. Certain design elements preclude full formal linking without compromising the environmental objectives of one of the programs, most notably price caps.

i. Formal linkage

The ideal case of linking is where formal agreements have been negotiated to allow GHG emissions credits issued by any linked GHG program to be accepted by all linking partners. Multilateral linking, where GHG credits are fungible among many GHG mitigation programs, most completely realizes the ideal of a single shared carbon unit and delivers the maximum possible benefit from a broad carbon market.

An incremental step toward this ideal is bilateral linking, where GHG credits are fungible between two GHG mitigation programs.

A special case of formal linking is unilateral, where one GHG mitigation program unilaterally allows GHG credits from another program to count for compliance purposes, such as the proposed acceptance of CERS in the Australian States' NETS or the RGGI acceptance of CDM credits under some price conditions.

ii. Informal Linkage

Where formal linkage between systems is not possible due either to substantive differences in design, or political constraints, it remains possible to have substantive linkage through informal mechanisms.

The most robust form of informal linkage is the 'common currency' model, the case where GHG mitigation programs mutually recognize a third program. This has not yet occurred between allowance markets, but the shared standards and acceptance of project-based credits such as the CERs produced by the Clean Development Mechanism have the potential to provide a connection between systems through a single freely exchangeable unit.



An example of this is the proposed Canadian system, which will be complicated to link to the EU ETS due to the use of intensity targets, but will allow for use of CERs. Unfortunately, the 10% limit on usage will mean that the linkage between the Canadian system and the EU ETS will be insufficient to drive price harmonization.

A proposed model of informal linkage would be an institution set up acting as a de facto carbon reserve bank. This would be an ambitious project that will require a strong balance sheet. Some coordination with public authorities would seem inevitable.

The weakest form of informal linkage is financial arbitrage. Market makers can provide an indirect linkage between different GHG regulatory programs on a cash basis, much as occurs in international currency markets. However, under this model, transactions costs will be relatively high, and efficiency will require large volumes. Critically, this model is least likely to deliver the carbon price harmonization necessary to ameliorate competitive concerns.

The mechanism most universally practicable at this time is the 'common currency' model described above, the construction of linkages through the shared use of CDM/JI credits. While IETA is optimistic that over time the political barriers to formal linkage will be negotiated down, this process itself may be facilitated by the growth of the carbon market through informal linkage.

As the largest and most liquid carbon market in the world, the EU ETS currently drives demand for CERs. In 2006 at least 69% of all CERs bought have been purchased by EU member states (Point Carbon, March 2007). However, an increasing number of the nascent carbon markets globally are proposing to connect to the global carbon market through the CDM. As noted, the Australian NETS will accept CER credits and be indirectly linked to the EU ETS through the CDM. The recent report of the Market Advisory Committee in California has advocated similar linkage. Both the Canadian system and the RGGI program in the Northeast of the United States have restricted access to CDM credits thus limiting the effectiveness of the link in creating price harmonization. In this regard, supplementary restrictions are equally restricting the potential of the EU ETS as the nucleus of a global carbon market.

4.4 Linking EU ETS to CDM and JI – Opportunities and Pitfalls

The CDM has shown tremendous growth over the last few years, CER transactions increased over 420% between the years 2004 and 2006, from 107 to 450 Mt CO₂e (World Bank & IETA, State and Trends of the Carbon Market 2006; State and Trends of the Carbon Market 2007).



With this grew all the benefits that accrue for having carbon finance flows, technology transfer and engagement of developing countries. While sovereign compliance has played an important role in the growth of this market, the main driver has been the EU ETS, which has had access to CERs and ERUs.

When discussing pitfalls and opportunities for linking CDM and JI to the EU ETS we must differentiate between what is in the jurisdiction of the EU and what is in UNFCCC/COP/CDM EB - some of the issues that we will highlight can be addressed through EU processes, while others are of the competence of the UN process.

Market Perspectives

For the period 2008 –2012 the demand/supply balance is roughly in equilibrium, if one does not consider Canadian demand, especially at the sovereign level, which is not likely to materialize. The market has responded to the current demand driven by ambitions from the Kyoto Protocol and the domestic instruments that it has generated, such as the EU ETS.

However, post-2012 demand for offset projects and credits can be expected to increase substantially, driven by deeper cuts, such as 20/30% to 2020 or the 50% discussed in the G8. In addition an increase demand can be expected beyond the current typical KP demand, from sources such as the voluntary market, possible US, Australian and Canadian demand and maybe other new sectors covered in the future.

It should be noted that the CDM mechanism is not being used in the US, where there seems to be a general belief that it is not an efficient program and that the US can set up a more efficient one. Real flaws are perceived in the CDM. These are amplified in the public debate, especially given its association with the KP.

Since most high volume projects, such HFCs and N₂O_s, will soon be cleared, under the current architecture and mindset of the CDM as a project-by-project instrument, we will require large number of projects that produce in the area of 100,000 /year.

Given this increase in demand, even if coupled with a more efficient and well resourced regulator (CDM EB and UNFCCC Sec), can the number projects required be processed in a timely and appropriate way? The current treatment of other factors, such as additionality, will also pose additional questions, if such high demand is to be addresses.

Improvements and efficiencies can be had from current mechanisms, but like in any other field a certain basic design and approach can and will only take you so



far. It is clear that the current offset mechanisms were designed to meet KP type targets and we may need different approaches for to satisfy deeper cuts.

In addition, it is likely that there will be increased demand for a geographical and sectoral project balance that is currently not well addressed.

Offsets are a temporary step to a global ETS. However, there is a need for the CDM in order to meet the objectives of the Lisbon and Göteborg agendas. IETA believes that there is no sunset for CDMs. In the event that there is a hiatus between the KP and a future agreement, clarification on the continuity of CDMs should be made a priority for the EU. This issue could be clarified in two ways:

- Either a provision is made for the continuation of a CDM-JI like program after 2012 or
- In negotiations, the flexible mechanisms should be moved from under the KP to the UNFCCC

If there is a lack of clarity, provision should be made for the continuation of the CDM-like mechanism as an EU program.

Finally, the role of JI and AAUs in the post-2102 period is also something that needs to be reviewed thoroughly. Many of the JI countries have joined the EU ETS and the amount of AAUs that may be available post-2102, depending on negotiations, amount used in Phase 1 and economic growth, may be lower than the current situation. This must be seen in conjunction with the demand/supply equation for CDM.

All these issues need to be addressed through practical steps and recommendations on items that the EU/EC can

- o Implement directly, or
- o Develop positions and recommendations to induce changes that are under the jurisdictions of the UN

Recommendations: Practical Steps

UNFCCC

The EU should strive to ensure that a CDM-JI like program continues after 2012.

Leading to 2012 the CDM can move from the current project-by-project approach, which given the volumes that are envisaged may be unworkable.



Another option will be for the UNFCCC to develop new mechanisms that would be designed under different premises. First and foremost we must model the programmatic CDM in such a way that it will make a difference, and allow large number of projects that be recognized and executed in a simple manner. The current debates in the CDM EB do help, but are unlikely to meet the test that it is envisaged. To accomplish the challenges ahead, the CDM EB needs to be made more efficient. Moreover, the current US resistance to the CDM needs to be addressed.

Benchmark baselines and sectoral approaches could be more appealing and hold the promise to process and deliver large number of project with greater ease. Combined with this, looking at additionality based on a benchmarking approach, such as currently examined by some sectors, could also ensure a much bigger uptake of offset projects especially by those in the multinational corporate sector.

EU/EC

The Linking Directive remains a critical element and must continue to be emphasized by the EU and the EC. Continued acceptance of post-2012 CERs will be important as well the provision of support for building and maintaining the infrastructure and the regulatory machinery involved therein, even if the CDM is intended to become self-funding.

The EU needs to start a process of thinking of the amount of offset credits that it may need post-2012 and see if current mechanism can help meet that demand. It needs to think through these matters and put forward positions based on those conclusions. Are the current mechanisms sufficient?

The inclusion of LULUCF in CDM must be seriously explored and should go ahead, while ensuring that scientific uncertainty has been addressed. This may help address the geographical imbalance with Africa, where many projects in this category projects can be done.

The EU should also ensure the inclusion of CCS in CDM, once all technical and scientific issues have been addressed. This way, CCS, a valuable technology, will be available to developing countries, which will continue, or increase, the use of fossil fuels.

Finally, IETA recommends that the European Commission calls a EU consultation on the future of the CDM-JI mechanisms. .

4.5 Quantitative limits: pros and cons of caps and complementarity



requirements

Following the general consensus, both Annex I and II countries will have to undertake their own share of action in order to tackle climate change. Within the Kyoto Protocol all Annex I countries are encouraged to take domestic action as part of their efforts to comply with the Kyoto targets. Politically, complementarity policies will provide both an incentive for domestic industries to take action as well as signal to those outside the scheme that real action is occurring domestically.

IETA and its members recognize the need to determine levels for supplementary. However, at the same time we would argue that such policies do weaken efforts of linking different ETS schemes and project based mechanisms, and restrict lower cost abatement activities that may occur outside of a particular ETS's jurisdiction.

IETA supports its members to undertake direct measures that reduce emissions reductions, whenever possible, within their own environment. However, IETA also sees that further restrictions on the use of emission reductions from outside a system will severely limit the system's ability to mobilise a significant amount of capital investment earmarked with this intent. That amount of capital, aimed at achieving emission reductions, could be equal to or more than the total that has been invested to date. Capital investments under any future scenario will likely require far greater investment than what has been seen thus far.

Present complementarity rules have resulted in varying compliance restrictions under the EU ETS. Complementarity levels found in NAP IIs currently vary from 0% to around 22% of the total amount of allowances surrendered by an installation to the member state. Such a variety in rules and limits will have a negative effect on the emissions market by limiting the potential of the supplying market to provide solutions to climate change.

With the increased need to take action and a growing number of activities elsewhere in developing ETSs and/or project based mechanisms, the current complementarity policies may also have to be expanded to these new programs. Reasoning for mirroring complementarity principles in developing ETSs might be either due to the overall scope of these programs or due to political considerations similar to those behind the complementarity rules of the KP. In both cases, IETA is of the opinion that such rules should not lead to prohibitive high abatement costs for industry or to a high level of complexity in order to implement complementarity policies. Clear guidance and policy setting at EU level is thereby essential.

Recommendation:



Although IETA recognizes the need for certain complementarity rules to demonstrate that member states put emphasis on achieving emission reductions domestically, IETA recommends that any such limits are set at European Level and with the intent and objective to lead to an overall abatement cost not prohibitive to the domestic industry.

4.6 Qualitative restrictions (gases, sectors and project types) on the use of offsets

The CDM has to date demonstrated the ability to provide credible emission reductions in volumes that have been in line with the reduction commitments under the Kyoto Protocol. However, the CDM has also demonstrated that current operations are clearly leaving some sectors behind due to a perceived complexity of the mechanism and/or varying interpretations of additionality.

In order to achieve a necessary future amount of reductions, both the CDM and JI must become mechanisms that are able to capture all sectors. Moreover, new tools for testing environmental additionality will be required. Tools that are more suited to the sectors that are not significantly represented in the flexible mechanisms might be developed. IETA puts emphasis on: a) clear methods of setting baselines, b) programmatic CDM, and c) sectoral approaches.

With the approval of the first LULUCF project and an increasing number of LULUCF methodologies, the CDM has demonstrated that Afforestation & Reforestation can be a viable option to achieve emission reductions, which should play a role in the European EU ETS market. Both the transportation and construction sectors are far from living up to their expectations as CDM activities, as only one project with transportation activities has been registered till now and the construction sector has not seen any project approvals yet. Although projects involving renewable energy sources make up 60% of all projects in the CDM pipeline, certain types or renewables account only for a minimal fraction. In particular projects with solar, tidal and geothermal activities so far form less than 1% of all projects that entered the project cycle (UNEP Risoe, June 2007).

Apart from methodological issues related to the registration of projects, significant experience has been gained in the administrative processes of project registration. Companies that currently have EU ETS compliance obligations in more than one Member State and want to use CERs for compliance purposes are required to obtain a Letter of Authorisation from each corresponding Member State. This is required only if they want to receive CERs directly into a respective Member State registry.



At the same time, within JI track II, companies have to respond to a multitude of project application conditions that depend on the individual Member State's agreement with the JI host country. Not only does this increase the burden on industrial participants in a JI project, but also on the administrative body of the Member State. Some countries wanting to participate in the flexible mechanisms of the KP may not be able to handle a CDM and/or JI project based on the administrative requirements to do so.

Harmonization of the approval process within the Member States around CDM & JI projects will lower the overall participation requirements for European actors to undertake a CDM or JI project.

Recommendation:

IETA recommends that the EU ETS should:

1. Ensure that projects categories currently excluded by the CDM, especially LULUCF, are included in the CDM. Similarly, CCS should also be part of CDM post 2012. In principle, there is no reason why not all CDM projects under the KP should not be accepted in the EU ETS
2. Explore and encourage the CDM & JI to adopt a more diverse approaches to demonstrating environmental additionality with the intent to increase participation of industries currently not significantly participating in the CDM & JI;
3. Further enhance the harmonisation of project approval among all the different Member States for both the CDM & JI.

5. Institutional and procedural aspects

5.1. Improvements in National Allocation Plans

Unless a European-wide allocation system is developed, National Allocation Plans (NAPs) will continue to be the instruments through which shortage in the trading system is created. NAPs should continue to demonstrate how each Member State plans to achieve its target emission targets.

This should include addressing sectors that are not covered by the EU ETS with the same level of ambition, in terms of emission reductions, as those in the trading scheme. It should also ensure that countries do not allocate more than their installations are realistically likely to need. Any perceived lack of environmental delivery will cause a serious crisis of market confidence in the EU ETS approach.



NAPs need to be more transparent. What would greatly contribute to this transparency is a predictable lay-out, English language, and the available of all NAPs on-line. Furthermore, their timely submission must be guaranteed in order to allow companies to have the maximum lead-time in which to formulate their emissions strategies.

Recommendation:

IETA recommends that National Allocation Plans clearly lay out how each MS will reach its Burden Sharing target. Reasonable penalties should be applied to MSs who submit their plans late (late submission hinders the installations covered in preparing their emissions strategy). Data pertaining to decisions on NAPs should be communicated in a predictable way to all interested parties, every NAP as well as corresponding communications should be conveyed in English.

5.2. The Relationship between the EU ETS and other market-based regulatory instruments

The LETs report, which is part of the Commissions LIFE Research Initiative, identified areas in which the EU ETS operates and either complements, overlaps, or clashes with existing policies.

According to the LETS report the following policies and measures that show the greatest potential for interaction with the EU ETS are:

- Integrated Pollution Prevention and Control (IPPC) Directive;
- Renewable Electricity (RES-E) Directive;
- Combined Heat and Power (CHP) Directive and
- Energy Performance of Buildings Directive (EPBD).

The LETS report considers that the greatest potential for interaction in the future will come from:

- Waste treatment Directives;
- Potential carbon capture and storage legislation;
- End-use energy efficiency and energy services legislation and
- The Directive on fluorinated gases.



The report concludes that any emissions policy review should consider interactions with other policies for the EU ETS where “interaction is defined at the level of the final goal of the system”, namely emissions reductions.

Recommendation:

IETA recommends that critical areas of overlap should be identified and a structured approach should be used to ensure that interactions are properly considered. It is important to consider interaction as policies develop at both the EU and Member State level.