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**EU ETS Linkages with other trading
schemes – Legal Issues**

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Project: Analysing the legal and organisational issues arising from linking the EU ETS to other trading schemes

1. Analysis of public international law and national law agreements, with a view to analysing the appropriateness of different operational frameworks to an agreement linking different emissions trading schemes
2. Identify core design principles
3. Explore legal and practical means to link schemes
4. Explore general legal conflicts between an agreement linking emissions trading schemes and international and/or regional trade laws
5. List the likely necessary structure of an agreement



Examples of legal issues raised by linking

- Relationship between EU ETS, Kyoto (IET), and linking agreement?
- Legal nature of traded unit?
- Legal status of linking partner?
- Legal nature/form of linking agreement?
- Unilateral or bilateral trades?
- Forum for enforcement?
- EU Competency issues and manner of adoption?
- Process for amendments, evolution over time?
- Trade impacts of form and content of agreement?
- Manner and effect of amendment/suspension/withdrawal/severance?



Legal nature of traded unit?

- Ton or tonne?
- Property right or authorisation to emit?
- KP – “KP has not bestowed any right, title or entitlement to emissions of any kind on Parties included in Annex I”
- RGGI – CO2 allowance is a limited authorization that does not constitute a property right
- EU ETS – silent



Nature of linking partner?

- Kyoto Parties who are not MS?
- EEA Countries (Kyoto Parties)
- Australia, US (Non-Kyoto Parties)
- Sub-national entities (RGGI, California, Australian States, Canadian provinces)
- Developing Countries (KP and non-KP)



Limitations on trades – Kyoto Protocol

- Limits eligibility to participate in IET to Kyoto Parties
- Limits units that can be traded (AAUs, CERs, ERUs, RMUs)
- Limits quantity of non-domestic units that can be used by a Kyoto Party toward compliance (*‘the use of the mechanisms shall be supplemental to domestic action and that domestic action shall thus constitute a significant element of the effort made by each Party...’*.(15/CP.7))
- Compliance reserve to be held to prevent over-selling
- These limitations are carried through to EU ETS in Directive, Linking Directive, and Registries Regulation
- Adherence to Kyoto limitations needed for credibility of EU climate policy



Limitations on linkages under Directive 2003/87/EC

Article 25(1): limits linkages by agreement to Annex B Kyoto Parties:

- “agreements should be concluded with *third countries listed in Annex B to the Kyoto Protocol which have ratified the Protocol* for the *mutual recognition of allowances* between the Community scheme and other GHG trading schemes in accordance with the rules set out in Article 300 of the Treaty.”

Article 12(1):

- *allowances can be transferred between persons within the Community and persons in third countries*, where such allowances are recognized under Article 25, without restrictions other than those contained in or adopted pursuant to the Directive.



Linking Directive

Paragraph (18)

- “following entry into force of the Kyoto Protocol, *the Commission should examine whether it could be possible to conclude agreements with countries listed in Annex B to the Kyoto Protocol which have yet to ratify the Protocol*, to provide for the recognition of allowances between the Community scheme and *mandatory* greenhouse gas emissions trading schemes *capping absolute* emissions established within those countries.”
(emphasis added)



Limitations - Linking Directive (2004/101/EC)

Article 11a(1)

- MS may allow operators to use CERs and ERUs from project activities in EU ETS *but only up to percentage* specified in NAP.
- All CERs and ERUs that can be used under KP can be used in EU ETS, *except* nuclear (refrain from use), LULUCF; rules for hydro
- Use takes place through issue and immediate surrender of an allowance by a MS for a CER or ERU held by the operator in the national registry



Registries regulation (EC No. 2216/2004)

Article 45 - all allowances are backed by AAUs

- the registry administrator shall issue the total quantity of allowances set out in the NAP into the Party holding account *by converting an equal quantity of AAUs held in that holding account into allowances.*
- Conversion takes place through adding the allowance element to unique unit identification code of each AAU

CITL – automated checks to ensure transactions comply with 2003/87/EC (as amended) and UNFCCC and KP reqs

Where MS approaches a breach of commitment period reserve (90% of AA, or 100% of 5x most recent inventory, whichever lowest), notification to MS



Registries regulation

Limits ‘transfers’ and ‘acquisitions’ of allowances to countries with agreements under Article 25(1) of Directive:

Article 49

- Allowances may only be *transferred* from an account in a registry to an account in a third country registry [KP ratifier, non-MS] or the CDM registry where an agreement has been concluded under Article 25(1) and transfers conform to provisions relating to mutual recognition
- Allowances may only be *acquired* from an account in a third country registry or the CDM registry *by an account in a registry where an agreement has been concluded under Article 25(1), and transfers conform to provisions relating to mutual recognition*

Article 1

- ‘*Third country registry*’ means a registry established, operated and maintained by a country listed in Annex B to the KP which has ratified the KP and which is not a Member State.



Legal nature/form of linking agreement?

1. Multilateral/bilateral treaty?
2. Political agreement?
3. Agreement to adopt reciprocal legislation with mutual recognition of traded units?
4. Private law agreements?
5. Indirect links? E.g., non-KP Party investments in CDM projects, or non MS holding of EUAs in EU-ETS accounts?



1. Multilateral/bilateral agreements

- **Central governing body of Parties, often a Joint Committee**
- **Scientific committee, expert groups** for advice and assistance – collect data, identify problems, recommending solutions
- **Meetings** – principal bodies every 1-2 years; extraordinary meetings when needed or at request; subsidiary body mygs depend on workload
- **Agreement Reviews** – periodic or triggers
- **Amendments** - process for adoption to bind all parties/ minimum number of acceptances/mechs for approval of technical changes
- **Severability/withdrawal** – based on notice/failure to meet membership criteria/automatic termination
- **Dispute resolution**
- Transparent, legally-binding
- Slow to negotiate, slow to amend
- Sub-national entities can't participate directly



Sub-national schemes and linkages?

- Treaties operate between two or more States or countries or international organisations; competency to enter into treaties varies from country to country and is usually set out in constitution
- Canada, Australia – only the federal government has the power to enter into treaties.
- US – Art. I, sec. 10 of US Constitution (Powers prohibited of States)– ‘no State shall, without the consent of Congress... enter into any Agreement or Compact with another State or with a foreign Power.
- US – Art. II, sec. 2 – ‘[The President] shall have Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur¹⁴



- Foreign affairs and foreign commerce powers reserved to US federal government; individual US states prohibited from entering into agreements with foreign powers without the consent of Congress – issue is whether the agreement pre-empts federal foreign affairs power
- US federal government could nevertheless endorse an agreement between a US state and a foreign entity, e.g., through a treaty attaching the agreement
- Where federal states have power to regulate emissions and establish GHG trading systems within their borders, something less formal than a treaty is suited for mutual recognition



2. Political arrangements

- Political announcement, Memorandum of Understanding, declaration of intent, joint statements
- Can be with sub-national entities (e.g., UK and California)
- Easy to negotiate, easy to amend, but not legally-binding



3. Reciprocal commitments

- Can agree to adopt reciprocal legislation in each jurisdiction, allowing for mutual recognition
- Legally-binding within each separate jurisdiction
- Creates security, transparency
- Easy to amend through changes in legislation
- Potential for unilateral termination, with market repercussions
- Need similar units, criteria for MRV
- Challenge: credits/permits from non-Kyoto Parties not backed by AAUs
- Independent system for validating project credits? Agreed criteria?



4. Private law agreements

- Contracts for delivery, swaps to engage in arbitrage between systems (standard contracts setting out terms for price, volume, delivery date, force majeure, default, liability provisions, choice of law etc.)
- Anyone can hold EUAs (person accounts) in a Member State registry, so EUAs could be used/bought by other schemes, if recognized in those schemes (e.g., Baxter/CCX transfer, cancellation on UK registry, issuance in CCX account).
- Trading of CERs could take place between MS and non-Kyoto Parties or sub-regional entities that plan to allow international credits as offsets (RGGI or California)
- Private entities, or government entities can engage in CDM investments through a MS registry



- Gateway could be created (e.g., to allow US units, not backed by AAUs and not acceptable for Kyoto compliance by Kyoto Parties, to be purchased by EU system), but only in the context of net sales of allowances from EU system, to remain Kyoto-consistent.
- EU purchases of US credits would only go through gateway provided that there are corresponding US purchases of EU allowances that exceed EU purchases, leaving EU as a net seller.



EU Competency issues

- Article 300
- Article 175
- Subsidiarity



Conclusions

- Different kinds of agreements may be needed to link with different partners
- Different kinds of agreements may be needed to address linkages at different levels
- Timeframe for desired linkage is important in deciding upon structure of agreement
- Differences in ambition or design elements of schemes to be linked may increase complexity of linking agreement(s)



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