

**ECCP EU ETS review process:
written comments CAN-Europe,
Friends of the Earth Europe,
Greenpeace and WWF**

June 2007



For more information please contact:

Tomas Wyns, EU ETS policy officer, Climate Action Network Europe (CAN-Europe):
tomas@climnet.org tel: +32 (0)2 229 52 23 m: +32 (0) 473 84 03 22

Sanjeev Kumar, EU ETS Coordinator, WWF European Policy Office:
skumar@wwfepo.org tel: +32 (0)2 743 09 20 m: +32 (0) 499 53 97 31

Mahi Sideridou, EU Climate & Energy Policy Director, Greenpeace European Unit:
mahi.sideridou@greenpeace.org tel +32 (0)2 274 19 04

Sonja Meister, Climate Change Campaigner, Friends Of the Earth Europe:
sonja.meister@foeeurope.org tel +32 (0)2 542 61 00

TABLE OF CONTENTS

0. Key recommendations for the EU ETS review	4
1. Introduction	5
2. General principles guiding the EU ETS review	6
2.1. Environmental and economical effectiveness.....	6
2.2. The EU ETS in the EU climate policy context.....	6
2.3. The EU ETS in an international perspective.....	7
3. Key design improvements for EU ETS post 2012	8
3.1. The total cap for the EU ETS post 2012 consistent with EU 2020 reduction target of 30% and stronger than the average.....	8
3.2. Cap-setting post 2012.....	8
3.2.1. National cap-setting does not work.....	8
3.2.2. EU wide top-down cap-setting.....	10
3.3. Full auctioning as allocation method post 2012.....	10
3.3.1. Free allocation, the sand in the EU ETS engine	10
3.3.2. Auctioning of allowances, the long march forward.....	12
3.3.3. Revenues from auctioning.....	13
3.4. A quantitative and qualitative limit of the use of CERs and ERUs	14
3.4.1. Unrestricted access of external credits threatens effectiveness and credibility of the EU ETS.....	14
3.4.2. Quantitative limit.....	15
3.4.3. Qualitative limit.....	16
3.4.4. No LULUCF credits in the EU ETS.....	16
3.4.5. Other credits that are not acceptable in the EU ETS	17
3.5. Linking the EU ETS with other ET schemes.....	17
3.6. Expansion of the scope.....	18
3.6.1. Expansion of the scope to other greenhouse gases	18
3.6.2. Expansion of the scope to other sectors.....	18
3.7. Monitoring, Reporting, Verification and Enforcement	19
ANNEX I: Structural overallocation in the period 2005-2007	21
ANNEX II: impact of NAPII decisions	24
ANNEX III: 2 examples of non-additional CDM projects	27

0. Key recommendations for the EU ETS review

General principles guiding the EU ETS review

- The review must maximise **the environmental and economical effectiveness** of the EU ETS.
- A **clear short and long term carbon price signal** to all parts of the production chain, resulting from short and long term cap setting in the EU ETS, is needed.
- The review requires the introduction of a **simple allocation method** with a clear carbon price signal and a thorough **harmonisation in the design and implementation** of the EU ETS.
- **Transparency and public participation** in the preparation and implementation of the EU ETS (review) remain essential for a broad public support of the EU ETS.

Design improvements for the EU ETS post 2012

- The post 2012 cap has to be consistent with the EU 2020 **reduction target of at least -30% compared to 1990 levels**.
- This cap has to be set **upfront top-down on an EU wide** level and not through the sum of national allocation plans.
- **All allowances auctioning have to be auctioned as from 2013**. Auctioning will create a clear price signal and is the most harmonised, transparent and efficient way to distribute allowances.
- The **revenues of auctioning** should be reinvested in climate change related policy areas.
- There is an urgent need for a stringent **quantitative (supplementarity) and qualitative (CDM Gold Standard) limit on the use of CDM/JI** credits in the EU ETS.
- The expansion of the EU ETS with other greenhouse gases (such as N₂O and CH₄ from coal mines) has to be considered very carefully on a thorough case by case basis.
- **LULUCF cannot enter** or link into the EU ETS because it will significantly harm the environmental effectiveness and credibility of the EU ETS.
- **Surface transport should be kept out of the EU ETS** because it will not enhance the environmental and economical effectiveness of the EU ETS.
- The inclusion of aviation into the EU ETS should only be seen as the first step in addressing the climate change impacts of the sector. Other policies and measures are needed.
- EU ETS installations have to remain excluded from participation in Joint Implementation on their site.
- **There can be no inclusion of domestic offsets and JI credits from EU countries into the EU ETS**. Again, these offsets have the potential to seriously harm the environmental effectiveness of the EU ETS.

1. Introduction

The existence of the EU emissions trading scheme (ETS) is a tremendously important achievement for European Climate Change policy. The EU ETS is a very important element of EU climate policy, as it covers presently over 40% of all greenhouse gas emissions from the 27 Member States.

The strength of a cap and trade system as a policy instrument is twofold. First of all it puts an absolute limit on the total emissions that can occur and therefore has the potential to guarantee environmental effectiveness. Furthermore it reduces emissions with the lowest possible compliance cost to all participants compared to other mechanisms. The EU ETS in particular is the most cost effective instrument for European industry and power generators to contribute to the reductions needed at EU level.

Support for a trading based instrument, a concept previously alien to EU environmental policy-making, increased in the late 1990s, following the frustrating experience of years spent on a debate on a carbon/energy tax, without tangible results in terms of a workable climate policy instrument. This support was and is based on the EU ETS delivering on the benefits it promised to maintain credibility to domestic audiences, including policy-makers, business representatives, NGOs and the general public altogether.

The EU ETS has not yet delivered its real potential to reduce emissions in a cost effective way. The trading period 2005-2007 has seen an over-allocation with the EUA price collapsing as a result. For the period 2008-2012 a more stringent cap has been set but the generous access to credits from JI and CDM will again limit the emission reductions taking place within the EU. In general, national based cap setting and allocation rules have lead to a non transparent, fragmented and inefficient implementation of the EU ETS. To maintain support for it in Europe, improvements in the EU ETS are of paramount importance.

This paper lays out our vision for a truly effective and efficient EU ETS post 2012.

If we want the EU ETS to reach its true potential for reducing CO₂ emissions in a cost effective manner, some general principles have to be taken into account. These principles relate to the environmental and economical effectiveness of the EU ETS, the role of the EU ETS in the general EU climate change policy framework and the (future of the) EU ETS in an international context. We will assess these general principles in chapter 2.

Not only the general rules for building an environmental and economical effective EU ETS are important sign posts, the lessons learned in the EU ETS so far clearly point towards the much needed design improvements. In chapter 3 of this document we assess the actual status of the EU ETS and present recommendations for the design of the EU ETS post 2012. This assessment is based on the results from the first trading period (2005-2007), key decisions taken for the period 2008-2012 and the state of play of the Kyoto mechanisms.

2. General principles guiding the EU ETS review

2.1. Environmental and economical effectiveness

The EU ETS has no end date. Although the second Kyoto Protocol commitment period (from 2013 onwards) has yet to be agreed, the EU has a firm commitment to reduce its greenhouse gas emissions by 30% from 1990 levels by 2020. Therefore the level of the cap in the EU ETS post 2012 has to be consistent with this short term EU reduction target as well as establishing a platform for further and more stringent global emission reduction targets.

However, the economic and environmental effectiveness of the EU ETS can only reach its maximum potential if the design of the EU ETS is optimised. Harmonisation and simplicity in the cap setting process and for the distribution of allowances will aid economic efficiency by creating a level playing field for fair competition within Europe. Furthermore, the allocation process must be transparent, economically efficient and result in a clear carbon price signal through the whole production chain.

The carbon price resulting from the ETS should act as a driver for investment into cleaner and more efficient technology in Europe's power sector and manufacturing industry, taking into account that most installations are in operation for decades.

If the signals in favour of lower-carbon plants from the ETS are not sufficient the European industry and power generators will lock in high levels of emissions from new installations in Europe's industrial landscape. These emissions would make achievement of future reduction targets very difficult and costly. It is, therefore, of paramount importance that the rules and caps are set in a fashion that they provide clear direction to emission reduction.

The development and deployment of new and better low carbon technology will suffer if there is no strong price signal from the ETS that promotes innovation. The development of new and less polluting technology requires the incentives to be deployed, so that they can be further improved and costs can be lowered.

2.2. The EU ETS in the EU climate policy context

The EU ETS is a very important element of EU climate policy, as it covers presently over 40% of all greenhouse gas emissions from the 27 Member States. At the same time it is part of a larger toolbox of measures.

It has been an essential recognition of the EU's climate policy strategy from the inception of the European Climate Change Program (ECCP) in the late 1990s that a wide range of common and coordinated policies and measures would be needed to address the diversity of emission sources. This was evidenced in the setting up of a stakeholder working groups differentiated by sectors and has resulted in legislation to address a multitude of climate change contributors from power plant CO₂ to enabling consumer choice for cleaner cars, to addressing fluorinated greenhouse gases from air conditions to supporting renewable electricity and so on.

In this context, it is important to understand that different sectors and sources need different instruments to address them effectively and efficiently. Emissions trading is not a one size fits all instrument that can usefully cover all emissions in the current policy context. This insight should guide considerations of additions and expansions to the system. Such inclusions in the EU ETS need to bring clear added value for the environment compared to using other policies.

To maintain support for it in Europe, improvements in the EU ETS are of paramount importance. An important element in this credibility challenge is linked to the ETS, but a more general concern for the EU climate policy: ensuring that reductions are made in the EU, and that the use of external Kyoto credits is strictly supplemental to such domestic efforts. Meeting target commitments by paying for reductions outside Europe will only proliferate existing technology and not spur research and development in Europe. The EU ETS should become a driver for innovation in Europe that will deliver those long-term benefits. There is also an international credibility issue to this, which is addressed below.

2.3. The EU ETS in an international perspective

The EU ETS has received a lot of global attention. This is because it is the largest global carbon market in terms of sectoral coverage, percentage of domestic emissions covered and the number of trades.

Implementation of the ETS is being regarded as the test case to whether the EU will deliver cost-effective reductions in greenhouse gas emissions. Emissions reductions in Europe are seen as a measure of the EU efforts to combat climate change and the commitment to long-term decarbonisation. The success or failure of the EU ETS in this regard will be judged by international partners and could impact on the future of the international regime for climate change as well as the linking of the trading scheme to other countries.

Developing countries like Brazil, India and China are monitoring what progress industrialised countries are making in reducing their emissions as a sign of how serious they are about taking action.

In addition, industrialised country partners like Japan and Canada that are part of Kyoto and the USA and Australia that have decided not to join the Kyoto Protocol, will be watching to see if the EU can deliver emissions cuts at home. Showing that domestic emission cuts are possible at low cost and presenting ways to achieve them could bring the USA back on board and ease negotiations for future targets.

Moreover, a functioning EU ETS could be linked with other trading systems around the world, in Japan and Canada as well as in developing countries. In theory, the EU ETS could also be connected to regional or federal level systems in the USA or Australia, even if these countries were to remain outside the international agreements for the immediate future. Such direct connections could build up the international climate mitigation system from the ground and facilitate global participation.

For the EU, showing that emissions can be reduced and at low cost, is an issue of environmental integrity as much as one of international credibility. As talks for the future of the international Kyoto system are continuing in Bali at the end of this year, it is particular importance that the EU shows that the EU ETS post 2012 will further deliver visible and significant emissions reductions in the EU.

3. Key design improvements for EU ETS post 2012

3.1. The total cap for the EU ETS post 2012 consistent with EU 2020 reduction target of 30% and stronger than the average

We share the EU goal of keeping average global temperature increases as far below 2°C as possible. Global emissions will need to peak by 2015 and to decline thereafter. A delay in action of only 5 to 10 years will require much more rapid reductions later to achieve the same environmental goal, at significantly higher cost. The need for urgent and profound action is undeniable.

Developed countries must take the lead in combating climate change. To allow developing countries a fair share of the global emissions budget, and in light of evidence that the climate is more sensitive to greenhouse gas concentrations than previously thought, developed countries need to reduce their emissions by at least 30% by 2020 and 80% by 2050.

The decision of the EU environment ministers (10 March 2007) to reduce greenhouse gas emissions by 30% by 2020 compared to 1990 is a step in the direction to achieve the above targets. This 2020 target has to be achieved within the EU.

However, setting targets is only the first step. Those targets, urgently, have to be linked to concrete policies and measures that will guarantee the achievement of the agreed reductions.

The emissions in the EU ETS represent more than 40% of the greenhouse gas emissions in the EU. Therefore the sectors in the EU ETS carry a great and historical responsibility in the overall greenhouse gas reduction targets set out by the EU.

Considering historical emission trends in other sectors (such as road transport), the ETS sectors should deliver significantly more than reductions than the average of a total EU target.

To be consistent with the EU 2020 reduction target, the EU ETS has to achieve emission reductions of at least 30% below 1990 levels in 2020. To provide stability the EU must give a clear indication of the likely EU wide target greenhouse gas emission reductions that are to be achieved in 2030, 2050 and 2080 and the expected contribution from the EU ETS in meeting these targets. This will provide business and industry with a clear understanding of the direction of future EU policy and commitment and thus facilitate investor confidence;

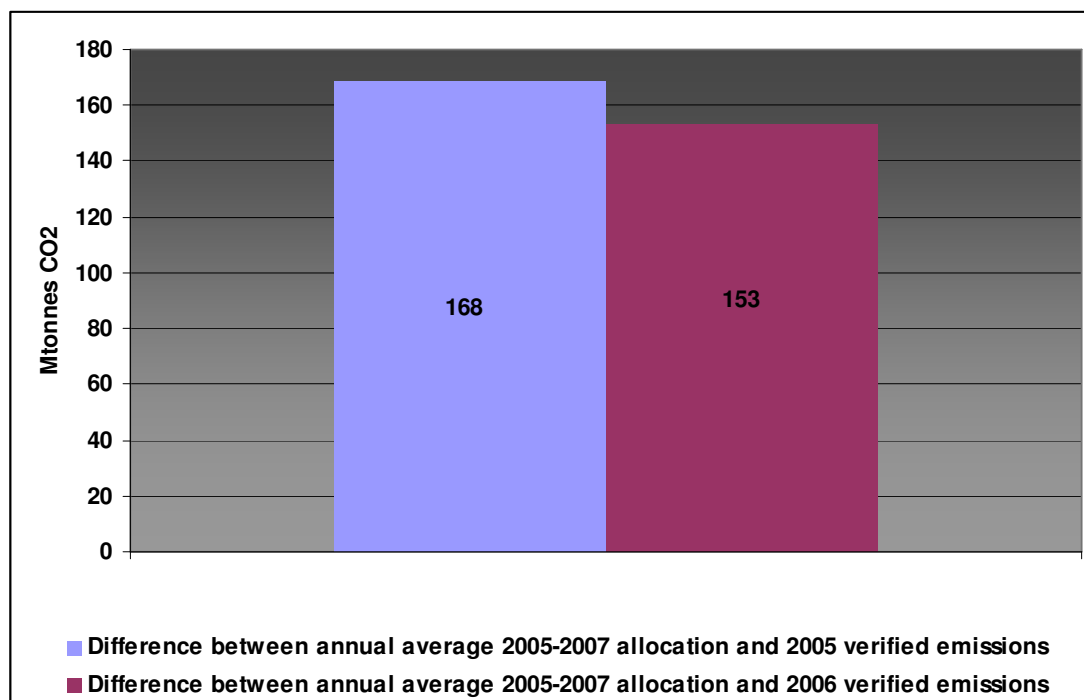
We would suggest that trading periods are not longer than 5 years as this would likely result in protracted negotiations unlikely to achieve a good result. They would also make the system inflexible in the case that faster tightening of targets is needed.

3.2. Cap-setting post 2012

3.2.1. National cap-setting does not work

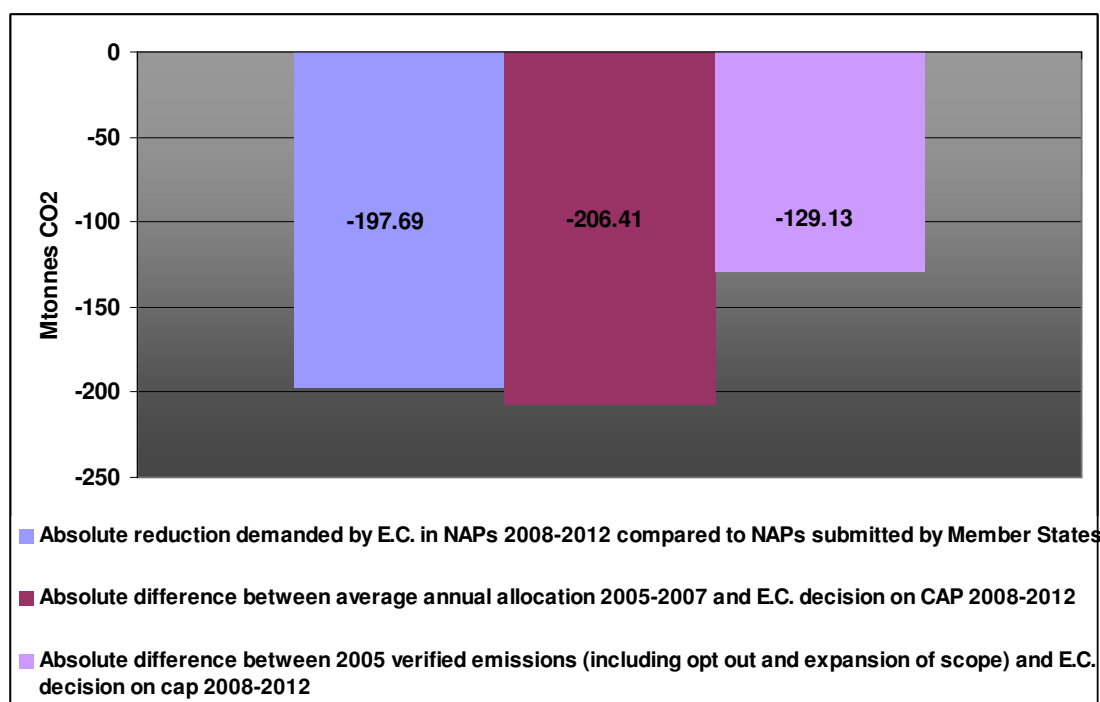
The fragmented implementation of the EU ETS through 27 different national approaches has been one of the main problems in realising the full potential of the EU ETS. This decentralised cap setting and allocation process lead to a non transparent and disharmonised EU ETS.

It also paved the way for the over-allocation in phase one of the EU ETS (see ANNEX I). Member States too often caved in on mostly unsubstantiated claims by EU ETS companies for more free allowances.



Structural over-allocation in EU ETS 2005-2007 (all country data except Malta)

Most Member States also tried to generously allocate their industry and power sectors for the period 2008-2012. The application of more or less uniform rules for the setting of national caps by the Commission, in its NAP approval process, has most likely prevented another dramatic EU ETS price crash for the second trading period (see ANNEX II).



Overview of total reductions following E.C. decisions on 22 NAPs 2008-2012.

The NAP approval process is complicated, lacks transparency and is time consuming: pointing to an inefficient allocation system. Furthermore, court cases resulting from this process again threaten the legal, environmental and economic stability of the EU ETS in the coming years.

The over-allocation in phase I and exhausting NAPII approval process indicate that giving Member States the responsibility of determining the total amount of allowances to be allocated is not in line with the subsidiarity principle. According to article 5 § 2 of the treaty establishing the European Community : «*the Community shall take action (...) only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States...*».

Indeed, the time for Community action has arrived.

3.2.2. EU wide top-down cap-setting

The above issues can be resolved through proper EU wide harmonisation of allocation rules and cap-setting.

An installation should receive the same treatment regardless of where it is placed in the EU, ensuring full transparency and a level playing field for business in an internal market.

Regarding the cap, an EU top-down target level will not need to be separated into national shares if all installations receive the same treatment. To ensure a transparent and environmentally effective EU ETS, the total amount of allowances to be allocated in the EU ETS post 2012 should be determined upfront at EU level and not be just the sum of caps in national allocation plans.

This will allow the EU ETS sectors to be treated as a separate entity in the EU target sharing of the EU's 2020 reduction target, facilitating this politically sensitive exercise tremendously.

3.3. Full auctioning as allocation method post 2012

3.3.1. Free allocation, the sand in the EU ETS engine

In the periods 2005-2007 and 2008-2012 the overwhelming majority of allowances will be handed out for free. The 5% and 10% limits for auctioning in the respective trading periods have, on an EU wide level, thus far not been reached.

Free allocation of allowances is seen as one of the main reasons why the EU ETS is not reaching its full potential in realising the promised environmental and economical effectiveness.

The distribution of free allowances has led to:

- the need for (in most cases) complicated and sometimes unclear rules to distribute these allowances;
- a distortion of competition between sectors and companies in the EU because of the above allocation rules inside and between countries can differ significantly;
- windfall profits, when EU ETS companies passed on the carbon cost for those free allowances;
- the need to construct rules on how new entrants can participate in the EU ETS and on how free allocated allowances (public goods) can be recuperated from closures.

Fundamentally, free allocation is in clear contradiction with the polluter pays principle. Free allocation gives no clear price signal that internalises the cost of carbon. It therefore slows down investments in energy efficiency, renewable energy projects and does not promote R&D in the above mentioned projects.

Announcements of new investments in high carbon power plants show that the New Entrant allocation rules are clearly not stimulating low carbon investments.¹ Furthermore, those investments will dramatically increase the cost of CO₂ reductions in the future.

Grandfathering, in different forms, has been used as the main allocation method in the EU ETS thus far. Grandfathering allowances emphasises some additional weaknesses in the process of allocating allowances for free.

- Grandfathering unfairly rewards historical big polluters.
- It does not reward early action in EU ETS installations.

Most of the Member States allocation plans tried to bypass the above concerns by constructing complicated allocation methods. However when we look at the installation level allocation and the verified CO₂ emissions this shows they clearly were not successful in avoiding the pitfalls of free allocation.

In theory benchmarking can solve some of the issues related to grandfathering. Although, and this has to be stressed, the main problems with free allocation also apply to benchmarking. Benchmarking still is a method in which allowances are given away for free.

Benchmarking indeed can recon for part of the early action in EU ETS installations and therefore eliminate part of the discrimination that arises from grandfathering.

However, we believe benchmarks will never deliver this promise. The first problem is that there is no definition of exactly what a clear, robust and transparent benchmark in an EU ETS context is.

Finding (even a definition of) benchmarks for the EU ETS will be complicated both on a technical and political level. Firstly it will be difficult to assemble the necessary data to start building benchmarks because that kind of information (i.e. specific energy use or CO₂ emissions per unit production) is regarded as being very confidential within companies.

Lessons learned from the IPPC Best Practice Reference guides (BREFs) show that establishing technical norms in the EU most likely will lead to a lowest common denominator instead of real best practice. Establishing benchmarks will inevitably lead to unhealthy compromises between and within sectors and Member States. Proof of the contrary would be a remarkable revolution in the EU's decision making process.

Benchmarks, even good ones (if they exist), remain a camouflaged form of grandfathering. A benchmark is a relative number (e.g. CO₂ emissions/unit of

¹ *"In many allocation plans, the new entrant rules give more free allowance to more carbon intensive fuels the German plan gives even more to the most polluting (lignite power plants). This implicit subsidy creates perverse incentives to construct new, high emitting facilities that would last for decades."* EU ETS Phase II allocation: implications and lesson, The Carbon Trust, May 2007.

production). To get to a real allocation this number has to be multiplied with an absolute number (e.g. historical or projected production). Establishing those numbers for different sectors and companies will lead to exactly the same problems that come with grandfathering (non transparency, discrimination, over-allocation, ...). It is no real solution.

We can only conclude that benchmarking will remain the *snake oil*² of the allocation process.

3.3.2. Auctioning of allowances, the long march forward

Auctioning of allowances is the only allocation method which gives a clear price signal, complies with the polluter pays principle and does not discriminate between sectors and companies in the EU. Full auctioning will resolve most of the issues related to free allocation such as grandfathering and benchmarking. It will:

- increase the macroeconomic efficiency of the EU ETS and address the distributional impacts
- reduce the distortions associated with free allocation
- be more compatible with EU State aid legislation
- increase management attention to emission reductions and thus market efficiency
- dramatically harmonise and simplify the allocation process;
- pose no significant implementation difficulties;
- eliminate windfall profits;
- eliminate the need for new entrant and closure rules.

Because of these dramatic improvements that will come to the EU ETS we strongly advocate that as from 2013 all allowances in the EU ETS will be auctioned.

The often used argument against auctioning is the economic discrimination between EU companies and companies outside Europe and the EU ETS, leading to leakage of CO₂ emissions. Evidence is growing that this argument is overstated³. We recommend that the European Commission should address this issue in detail in its impact assessment for the EU ETS review. Until this information is made clear, the Commissions proposal for the EU ETS review must start from the basis of full auctioning. Furthermore, we invite sectors and companies to present clear examples of the extent to which they are under alleged international competition and therefore cannot pass on costs to consumers.

Auctions can take place frequently at national level (as fiscal matters cannot be easily solved from the EU level), be open for access to all market participants, and be carried out in the most transparent manner under rules harmonised at EU level. Allowances not sold at the end of the last auction in the trading period have to be cancelled.

² http://en.wikipedia.org/wiki/Snake_oil : "**Snake oil** is a traditional Chinese medicine used to treat joint pain. However, the most common usage of the words is as a derogatory term for compounds offered as medicines which imply they are fake, fraudulent, or ineffective. The expression is also applied metaphorically to any product with exaggerated marketing but questionable or unverifiable quality."

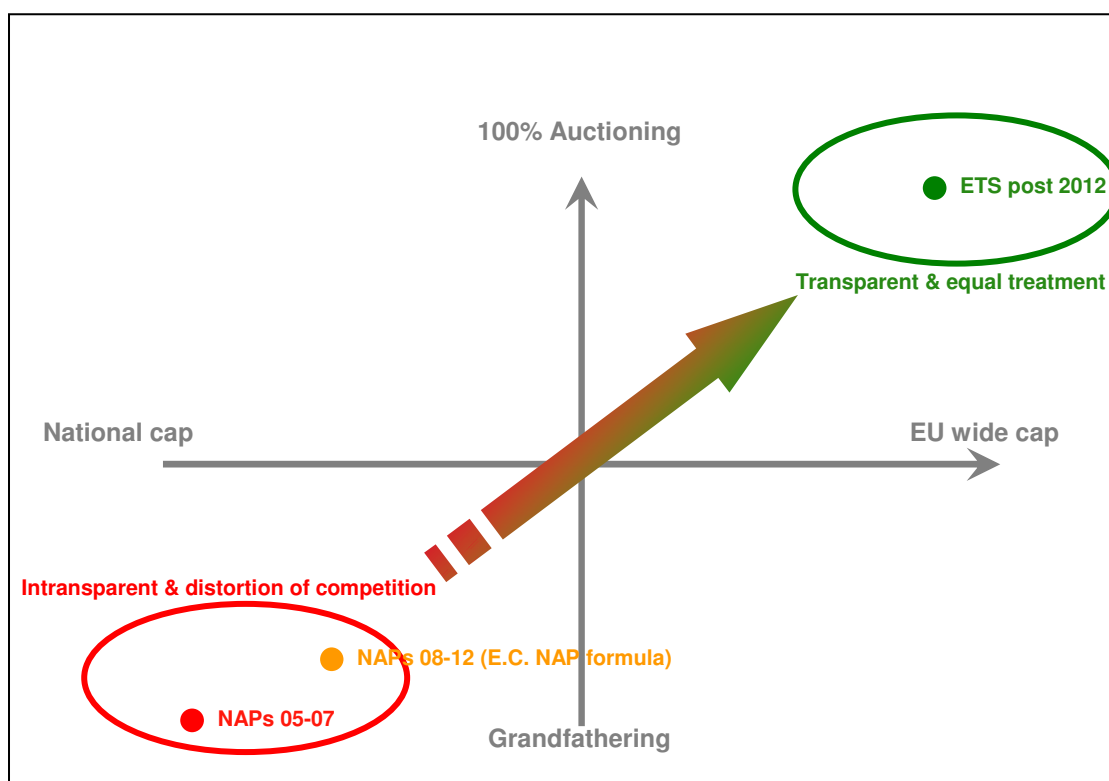
³ Climate Strategies, "Differentiation and dynamics of EU ETS competitiveness impacts", March 2007, http://www.climate-strategies.org/uploads/Compet_report_070530.pdf

3.3.3. Revenues from auctioning

Auctioning of allowances will generate revenue for EU governments. Since those revenues are generated by activities inflicting damage to the planet it is logical that they are used to mitigate and/or prevent actual and further damage.

We strongly recommend that the revenues should be reinvested in climate change related policy areas such as:

- funding for adaptation against climate change in developing countries;
- green technology transfer to developing countries;
- investments in renewable energy and energy efficiency;
- environmental tax reform (e.g. decreasing tax burden on labour costs which will lead to higher employment and higher competitiveness);
- ...



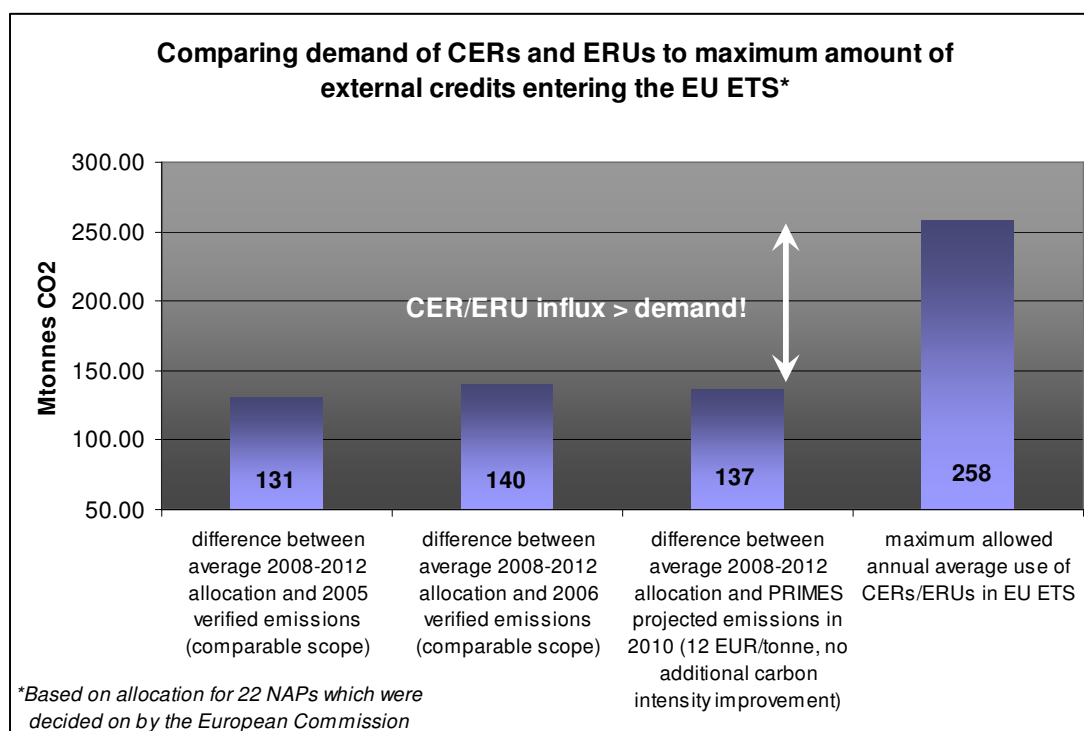
Charting the future of the EU ETS

3.4. A quantitative and qualitative limit of the use of CERs and ERUs

3.4.1. Unrestricted access of external credits threatens effectiveness and credibility of the EU ETS

During the negotiations on the linking directive, amending the EU ETS, environmental NGOs consistently demanded strong quantitative and qualitative limits on the use of CDM and JI credits in the EU ETS. In the approved linking directive (2004) both were notably absent. In the mean time important information and experiences show that such limits are more than necessary.

So far the maximum percentage of CERs/ERUs that can be used in the trading period 2008-2012 stands at 13.6% of the amount of allowances to be allocated. For the 22 NAPs on which the Commission has decided this means around 258 Mtonnes CO₂ per annum that can enter the EU ETS in the form of CERs and/or ERUs. The table below shows that the shortage (i.e. the total allocation compared to expected emissions) in the EU ETS will likely be lower than the maximum influx of these external credits. With an oversupply of CERs and ERUs the marginal EU allowance (EUA) price will come down to the marginal CER price. CER prices after 2012 are expected to trade at 15 EUR/tonne or lower. This low EUA price will prevent most of the emission reduction from place in the EU ETS.



The weak restrictions on the amount of external credits that can be used in the EU ETS are therefore placing a serious limit on the environmental effectiveness of the EU ETS. With most of the reductions taking place outside of the EU⁴ the use of external credits is by definition not supplemental to intra EU reductions.

Unfortunately not only the quantity of CERs entering the EU ETS can be questioned.

⁴ Only in a best case scenario when a CER or an ERU really represent a reduction if they are resulting from a project that is additional.

While we fully support the principle of facilitating net global greenhouse gas emission reductions, we are, however, concerned about the lack of effective scrutiny on 'loose' applications of additionality, sustainable development and overall environmental impact in the CDM.

Recent revelations in the international press⁵ point to serious deficiencies in the Clean Development Mechanism (the mechanism from which those CERs that will enter the EU ETS originate). During the last ECCP EU ETS review meeting (15/06/2007) an expert of the CDM executive board methodology panel pointed out that up to 50% of the CERs offered to the carbon market do not represent real emission reductions. This is in clear contradiction with Article 12⁶ of the Kyoto protocol, which says that the CDM projects need to result in real, long term and measurable emission reductions. The methodology for assessing reductions or the monitoring of the projects emissions clearly shows some major deficiencies.

There is another part of this important Article 12 that has, recently, been put to the test. According to the Kyoto protocol the CDM shall promote sustainable development in the host countries. Again there are plenty examples of CDM projects which are not delivering on that point. Even worse some CDM projects are truly in contradiction with sustainable development. Examples are large hydropower (CDM) projects that destabilise local communities or CDM *cash cow* HFC22 projects which are now putting pressure on the timely implementations of the Montreal protocol for the protection of the ozone layer.

In ANNEX III we present 2 clear examples of CDM projects that are not additional or are not in line with sustainable development.

3.4.2. Quantitative limit

The experience with the NAPs for the period 2008-2012, as discussed above, demonstrates the need for a strong quantitative limit on the access of CDM/JI credits to the EU ETS.

The overwhelming majority of emission reductions have to take place within EU ETS sectors: the use of CDM/JI credits has to be supplemental.

In the past there have been unsuccessful efforts to quantify this supplementarity principle. **We strongly suggest that the quantification of the use of external credits to be based on the difference between historical emissions (i.e. not projected emissions) and the post 2012 targets. The majority of the above determined effort has to take place within the EU ETS.**

⁵ The Guardian 02/06/07: "Abuse and incompetence in the fight against global warming."
<http://environment.guardian.co.uk/climatechange/story/0,,2093835,00.html>

⁶ The article that establishes the CDM

3.4.3. Qualitative limit

So far only CDM projects accredited under the ‘**CDM Gold Standard**’⁷ truly are additional and benefit sustainable development. This standard is the only guarantee that emission reductions not taking place in the EU ETS are compensated by real reductions taking place elsewhere in the world.

"The Gold Standard" is an independent, transparent, internationally recognised benchmark for "high quality" CDM projects.

The Gold Standard, amongst others, only certifies projects which meet the following criteria:

- they must be end use efficiency or renewable energy projects (this includes methane to energy in certain circumstances);
- they must pass a sustainable development screen i.e. there must be evidence that the project is making a real contribution to sustainable development and that it benefits the local community;
- they must only provide an energy service that helps catalyse the transition to non-fossil fuel based energy systems. Projects which generate credits from the destruction of industrial waste gases such as HFC's are therefore not eligible. These projects have little or no wider sustainable development benefits and
- they must follow a conservative, guided interpretation of the UNFCCC-additionality test that is necessary to demonstrate that a project delivers real emission savings which would not have occurred anyway under 'business as usual'.

Only CDM credits from 'CDM Gold Standard' accredited projects should be allowed to enter the EU ETS. If there is no quality assessment of credits entering the EU ETS, the amount of CERs entering the EU ETS has to be zero.

Each CER has a unique project identifier. The implementation of the above quality assessment is therefore quite straightforward through a simple IT add-on to the Community Independent Transaction Log (CITL). This *CER quality firewall* will only allow CERs to be used in a operator's compliance account if they originate from projects accredited through CDM gold standard.

3.4.4. No LULUCF credits in the EU ETS

We strongly oppose the access of credits (CERs/ERUs) from LULUCF projects to the EU ETS. The key issues with sinks projects remain:

- **Non-permanence** - Fires, pest attacks, increasing weather extremes and increase in the need for agricultural land are likely to turn today's sinks into future sources.
- **Additionality** – establishing additionality requires the establishment of a reliable baseline, which must represent what would have happened without the project.
- **Leakage** – the implementation of a sinks project will influence emissions outside the project boundary to a much larger degree than non-sinks projects.
- **Uncertainties** – associated with the measurement of changes in carbon stocks and emissions of other greenhouse gases within the project area as well as uncertainties with calculation of the carbon offset itself.

⁷ www.cdmgoldstandard.org

- **Socio-economic and environmental impacts** – negative impacts need to be minimised and biodiversity benefits should be maximised, and there is no assurance that sinks projects are consistent with goals and objectives of the CBD or the CCD⁸. In fact, many sinks projects, including those that entered the CDM approval process, have already sparked controversies on the basis of their negative social or environmental impacts⁹.

3.4.5. Other credits that are not acceptable in the EU ETS

Electricity generated by **nuclear power** plants is not a sustainable form of electricity production. Therefore nuclear power plants are directly breaching the sustainable development criterion of Article 12 of the Kyoto protocol establishing the CDM. Nuclear power is not acceptable as CDM project.

EU ETS installations will remain excluded from participation in Joint Implementation on their site.

We are opposed to the inclusion of domestic offsets and JI from EU countries into the EU ETS for the following reasons:

- they do not reduce the net amount of greenhouse gas emissions. They only allow a capped sector to emit more CO₂ emissions;
- if there is significant greenhouse gas abatement potential in a sector (for example transport) then arguably it should be governed by a separate policy and not be used to allow emissions from the ETS sectors to grow;
- ad hoc development of projects is not a particularly effective way of tackling emissions from a sector. Indeed the inclusion of domestic offset projects may be used as an excuse to delay the implementation of a more focussed policy for a sector;
- inclusion of domestic offsets may make it more complicated to determine the direct contribution of the ETS sectors to EU greenhouse gas emission reduction targets and to determine whether they are playing their fair share or not;
- there is the risk of double counting of emissions reductions - both as a contribution to meeting the EU ETS cap, and towards achieving international emission reduction targets;
- access to project credits (be they from from JI/CDM or domestic offset projects) could make it cheaper for ETS sectors to meet emissions caps. But access to significant volumes of credits could disincentivise investment in clean technology within those sectors and slow down innovation. Crucially, it could help to “lock in” decisions on high-carbon infrastructure (of particular pertinence here for the power sector) which would have a significant impact on emissions from those sectors for many years to come.

3.5. Linking the EU ETS with other ET schemes

A functioning EU ETS could be linked with other trading systems around the world, in Japan and Canada as well as in developing countries. In theory, the EU ETS could also be connected to regional or federal level systems in the USA or Australia, even if these countries were to remain outside the international agreements for the immediate future. Such direct connections could build up the international climate mitigation system from the ground and facilitate global participation.

⁸ Convention on Biological Diversity and Convention to Combat Desertification.

⁹ For more information see: <http://www.wrm.org.uy/bulletin/76/dumps.html>

Linking the EU ETS with other ET schemes can improve the environmental and economic effectiveness of the EU ETS. Each possible external link with the EU ETS has to be considered carefully.

The following design elements in other ET schemes are essential:

- only links with other cap and trade systems. No links with baseline and credit systems or ET schemes with relative caps.
- linkable ET schemes must have mandatory participation and have similar ambitious absolute caps;
- no links with ET schemes which have a price cap;
- only links to systems with similar scope (CO₂ emissions from large industrial point sources);
- only links to other ET schemes with comparable quantitative and qualitative restrictions on use of project credits;
- linkable ET schemes must have equally robust monitoring, reporting, verification, compliance and enforcement procedures.

3.6. Expansion of the scope

3.6.1. Expansion of the scope to other greenhouse gases

The expansion of the EU ETS with other greenhouse gases (such as N₂O and CH₄ from coal mines) has to be considered very carefully on a thorough case by case basis. We request the European Commission to make this analysis based on the environmental effectiveness of adding other gases to the EU ETS compared to other policies and the availability of excellent monitoring, reporting and verification standards for those gases. Windfall profits and hot air from sectors that have made reductions due to other policies or circumstances must be avoided.

3.6.2. Expansion of the scope to other sectors

Surface transport should be kept out of the EU ETS. Instead the focus should remain on the urgent implementation of targeted policies such as mandatory fuel efficiency targets (a maximum of 120g CO₂ per km by 2012), complemented by robust fiscal incentives and other measures to reduce the growth in road traffic.

The main reasons for keeping surface transport out of the EU ETS are:

- It is not likely to lead to fuel efficiency improvements in vehicles;
- If manufacturers are included they are likely to be net purchasers of credits. This means that they are not likely to make any greenhouse gas reductions themselves and instead increase the burden on other sectors in the EU ETS;
- Manufacturers have no control over fuel consumption and lifetime carbon emissions once the vehicle has been sold (e.g. how the vehicle is driven, what distances it covers etc.). Although methods have been proposed for calculating manufacturers' greenhouse gas emissions, significant uncertainties would surround many of the figures used e.g. what would be the average emissions from a flex-fuelled car which could run on bio-fuel or petrol? The uncertainty over emissions levels and hence the accuracy of the cap that was set could therefore undermine the integrity of the EU ETS as a whole.
- Inclusion is not likely to lead to direct emission reductions in the sector and could 'lock in' high carbon infrastructure and behavioural choices which will be difficult or costly to reverse at a later date;
- Other more effective and efficient measures for addressing surface transport issues must be given priority such as the current Fuel Quality Directive discussions

With regard to including **aviation (and shipping)** in the EU ETS, key principles have to be maintained:

- adding those sectors has to enhance the environmental and economical effectiveness of the EU ETS. The addition to the EU ETS still has to imply that the majority of reductions have to take place within the concerned sectors;
- adding these sectors to the EU ETS cannot mean that other measures to reduce greenhouse gas emissions are excluded as further policy options;

The inclusion of aviation into the EU ETS should only be seen as the first step in addressing the climate change impacts of the sector. Other policies and measures are needed and this has also been recognised and recommended by the European Parliament in its resolution of June 2006. We consider these measures should include:

- a kerosene tax on fuel for domestic flights, and where there is agreement a tax on fuel on flights between two member states;
- the immediate ending of VAT exemption, for example with a tax on air tickets;
- en-route NOx emissions charges (once the current ICAO moratorium expires in October of this year); and
- a concrete proposal on tackling contrail-formation, where appropriate. Work to quantify the impacts of contrails and contrail cirrus and to determine appropriate Air Traffic Control measures to mitigate them should be prioritised.
- improved air traffic management systems and more direct routing;

Furthermore, measures to constrain capacity are also essential if emissions from aviation are to be adequately controlled.

It is *absurd* to add LULUCF as a sector to the EU ETS. Besides the fact that sinks are fundamentally incompatible with the actual scope of the EU ETS (i.e. large industrial point sources) there are essential and dangerous issues related to the use of sinks in the EU ETS. Those issues are the impermanence of sinks, uncertainty with regard to monitoring sinks and the fact that is very difficult if not impossible to assess the additionality of sink projects. Adding LULUCF to the scope will harm the environmental effectiveness of the EU ETS significantly (see also 2.4.4.).

3.7. Monitoring, Reporting, Verification and Enforcement

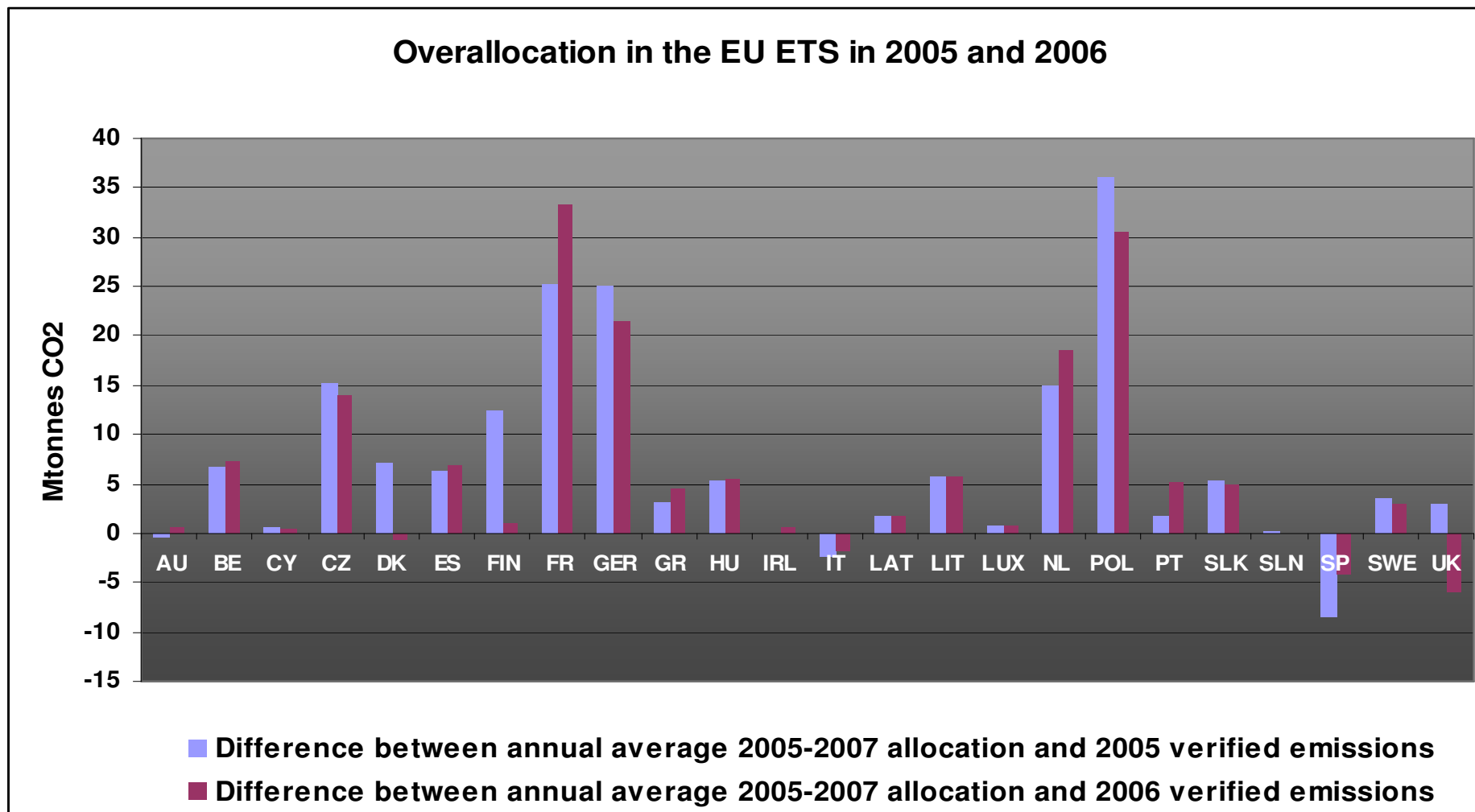
The Monitoring and Reporting Guidelines (MRG), together with the verification form the important technical backbone of the EU ETS. The current and amended MRG provide high quality standards for monitoring and reporting CO₂ emissions. However, in practice, the implementation of those guidelines has not occurred on a satisfying level. Furthermore, harmonised and legal rules on the verification and enforcement of the CO₂ monitoring and reporting are missing in the current EU ETS.

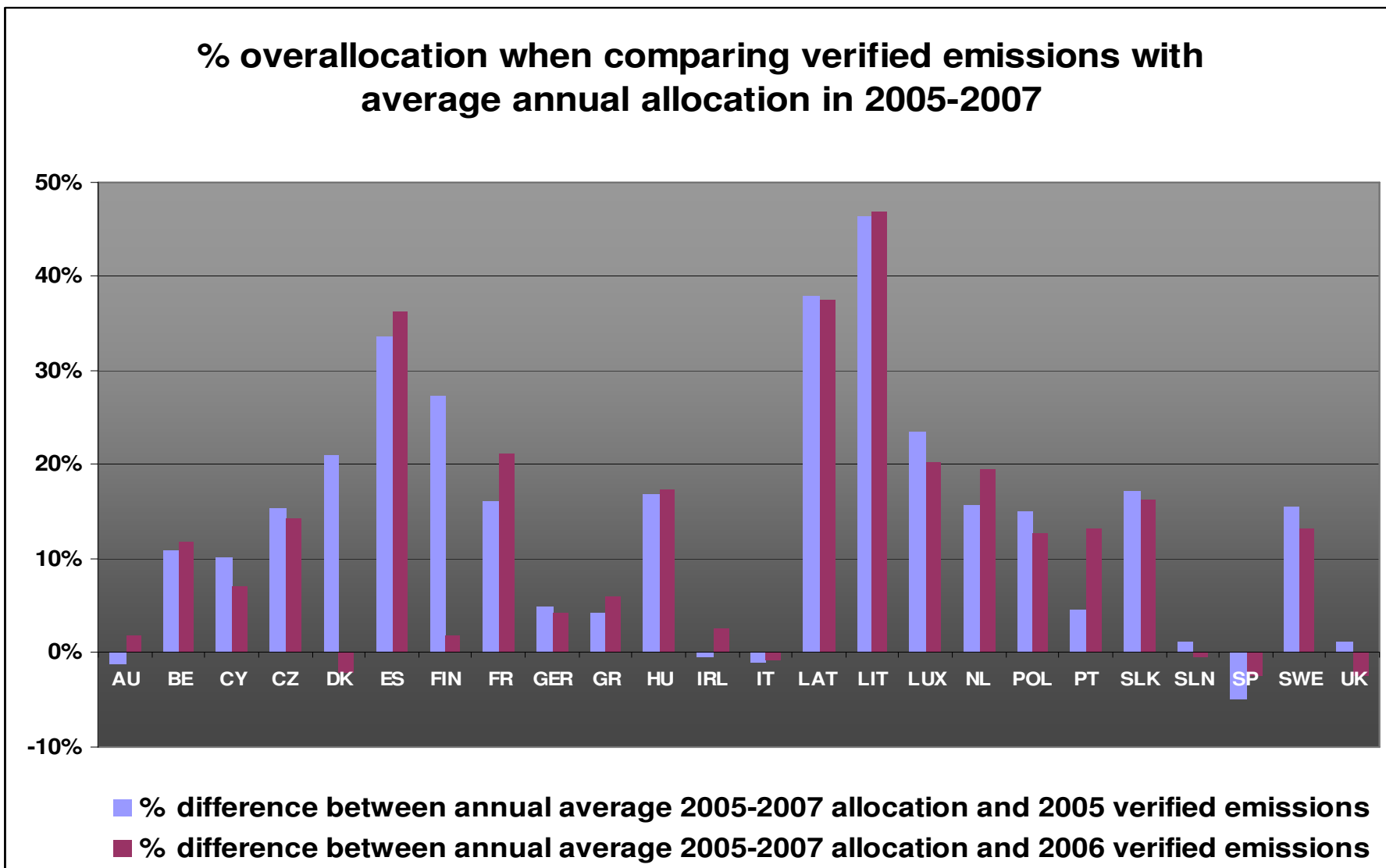
To improve the reporting of CO₂ emissions we propose the following changes:

- regular on site verification is essential for an effective monitoring of CO₂ emissions;
- results from verification of CO₂ reports have to be linked back to the monitoring protocol. This means that results of the verification have to relate to the monitoring protocol and the GHG permit.
- an in country expert review of the implementation of the MRV rules for each trading period must take place in every Member State.
- the fines and enforcement process for not complying with the MRV rules must become part of the directive and not be left to the competent authorities.

Written comments CAN-Europe, WWF, Greenpeace and Friends of the Earth Europe
ECCP EU ETS review process

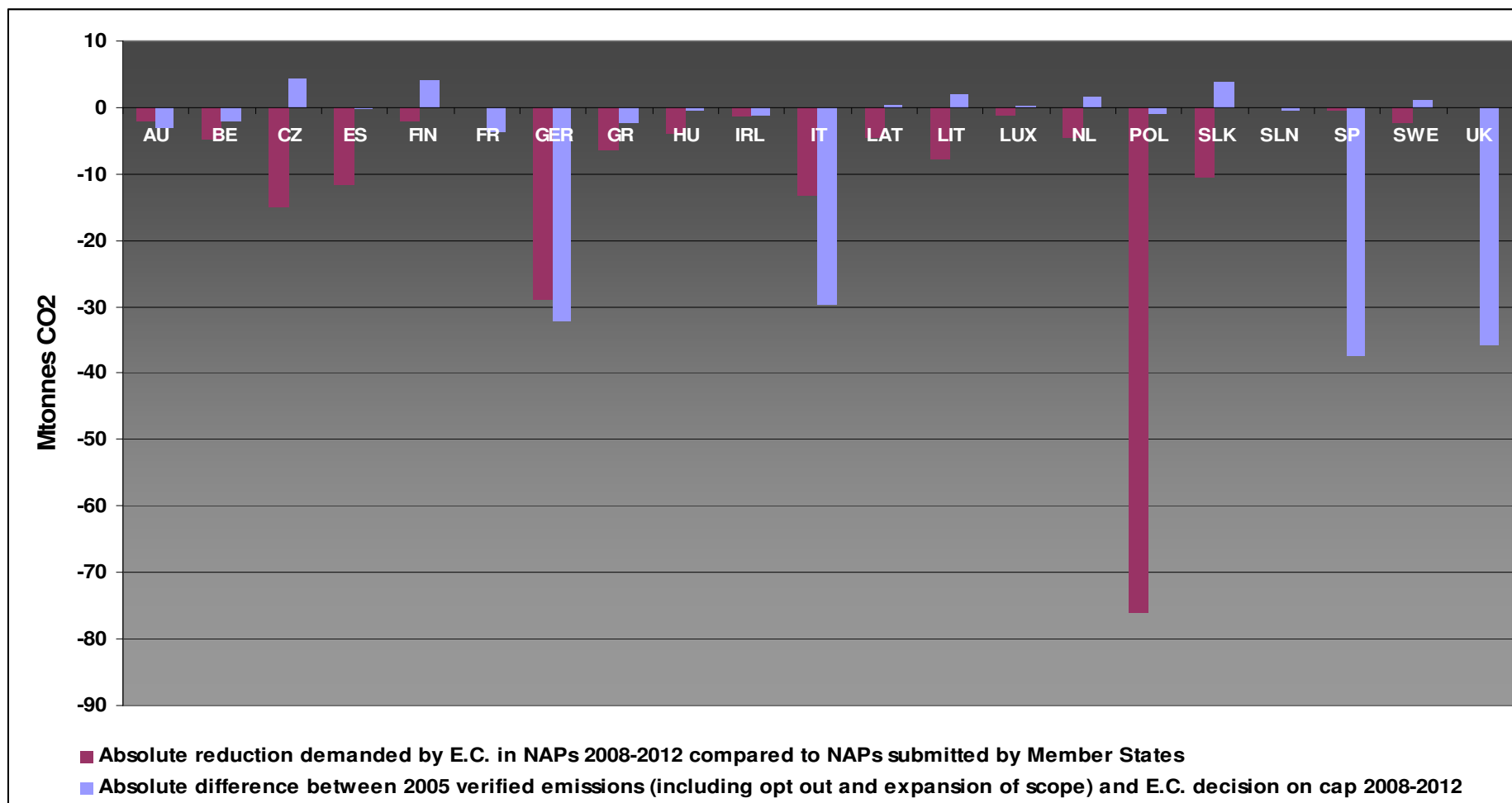
ANNEX I: Structural overallocation in the period 2005-2007

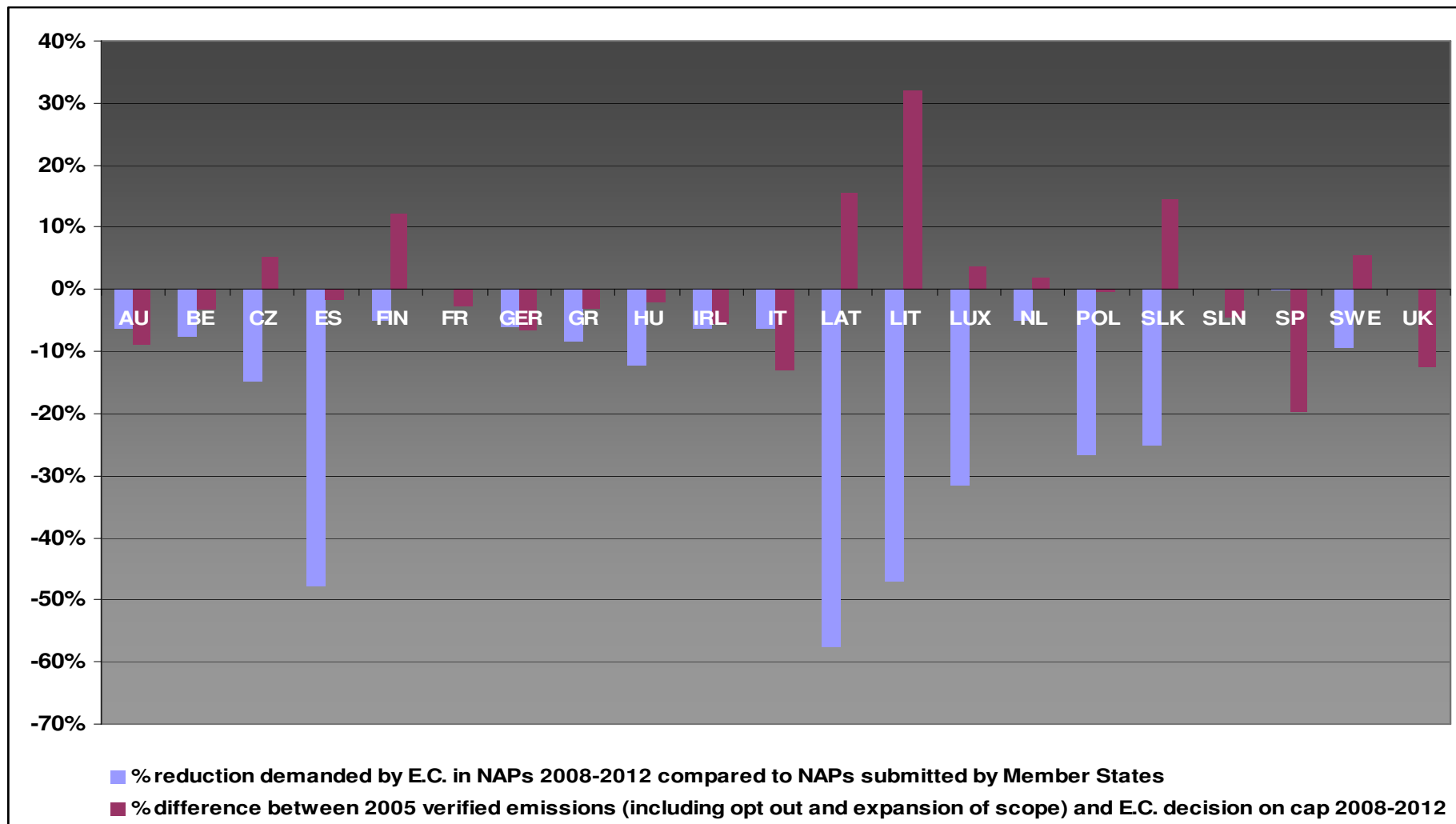




	Member State (ordered according to absolute overallocation)	Difference between annual average 2005-2007 allocation and 2005 verified emissions (Mtonnes CO2)	Difference between annual average 2005-2007 allocation and 2006 verified emissions (Mtonnes CO2)	% difference between annual average 2005-2007 allocation and 2005 verified emissions	% difference between annual average 2005-2007 allocation and 2006 verified emissions
1	POL	36.00	30.47	15.06%	12.75%
2	FR	25.20	33.21	16.10%	21.22%
3	GER	24.94	21.44	5.00%	4.30%
4	CZ	15.10	13.98	15.47%	14.32%
5	NL	14.95	18.60	15.69%	19.52%
6	FIN	12.40	0.88	27.25%	1.93%
7	DK	7.02	-0.70	20.97%	-2.09%
8	BE	6.73	7.30	10.83%	11.77%
9	ES	6.38	6.89	33.58%	36.27%
10	LIT	5.70	5.78	46.31%	47.02%
11	HU	5.30	5.47	16.93%	17.46%
12	SLK	5.27	4.96	17.27%	16.25%
13	SWE	3.58	3.02	15.65%	13.18%
14	GR	3.15	4.43	4.23%	5.96%
15	UK	2.90	-5.83	1.18%	-2.38%
16	LAT	1.75	1.73	37.95%	37.58%
17	PT	1.74	5.09	4.57%	13.32%
18	LUX	0.80	0.69	23.43%	20.21%
19	CY	0.58	0.40	10.27%	7.08%
20	SLN	0.10	-0.04	1.14%	-0.48%
21	IRL	-0.10	0.60	-0.45%	2.68%
22	AU	-0.40	0.62	-1.21%	1.87%
23	IT	-2.40	-1.72	-1.08%	-0.77%
24	SP	-8.50	-4.18	-4.87%	-2.40%

ANNEX II: impact of NAPII decisions





	Member State (ordered according to absolute reduction demanded by E.C.)	Absolute reduction demanded by E.C. in NAPs 2008-2012 compared to NAPs submitted by Member States (Mtonnes CO2)	Absolute difference between 2005 verified emissions (including opt out and expansion of scope) and E.C. decision on cap 2008-2012 (Mtonnes CO2)	% reduction demanded by E.C. in NAPs 2008-2012 compared to NAPs submitted by Member States	% difference between 2005 verified emissions (including opt out and expansion of scope) and E.C. decision on cap 2008-2012
1	POL	-76.10	-0.90	-26.74%	-0.43%
2	GER	-28.90	-32.07	-6.00%	-6.61%
3	CZ	-15.10	4.30	-14.82%	5.21%
4	IT	-13.20	-29.70	-6.32%	-13.17%
5	ES	-11.66	-0.21	-47.83%	-1.62%
6	SLK	-10.40	3.94	-25.18%	14.61%
7	LIT	-7.80	2.14	-46.99%	32.11%
8	GR	-6.40	-2.22	-8.48%	-3.11%
9	BE	-4.83	-2.04	-7.62%	-3.37%
10	NL	-4.60	1.53	-5.09%	1.81%
11	LAT	-4.47	0.45	-57.52%	15.61%
12	HU	-3.80	-0.53	-12.38%	-1.93%
13	SWE	-2.40	1.20	-9.52%	5.53%
14	AU	-2.10	-3.05	-6.40%	-9.04%
15	FIN	-2.00	4.10	-5.05%	12.24%
16	IRL	-1.45	-1.25	-6.42%	-5.58%
17	LUX	-1.25	0.10	-31.65%	3.71%
19	SP	-0.40	-37.30	-0.26%	-19.67%
20	FR	0.00	-3.60	0.00%	-2.64%
21	SLN	0.00	-0.40	0.00%	-4.60%
22	UK	0.02	-35.70	0.01%	-12.66%

ANNEX III: 2 examples of non-additional CDM projects

Examples from WWF-UK report (June 2007): “Access to JI/CDM credits in phase II of the EU Emissions Trading Scheme - a cause for concern”

Example 1:

Xiaogushan hydropower project in People’s Republic of China

Host: China **Status:** registered **Type:** hydro
ktCO₂ per year: 313 **Years:** 10 **Credit start:** 1 March 2006

Concern raised: project is not additional

This project was registered by the CDM Executive Board despite a submission from the International Rivers Network to the project validators, Japan Consulting Institute Clean Development Mechanism Center, prior to validation in August 2005 which stated:

“Xiaogushan is non-additional and therefore cannot be validated as a CDM project. Project documentation from the Asian Development Bank clearly states that Xiaogushan was the least cost option for Gansu and that revenue from CDM credits (CERs) was irrelevant to the decision to go ahead with the project. Construction began in October 2003¹⁰.”

This project is now due to receive more than \$30 million worth of credits through the international carbon market¹¹.

Example 2:

22.5 MW Bhilangana Hydropower project (BHPP)

Host: India **Status:** registered **Type:** hydro **ktCO₂ per year:** 109
Years: 10 **Credit start:** 16 April 2007

Concerns raised: no satisfactory stakeholder consultation, likely negative environmental impact, project is not additional.

In June 2006 the South Asia Network on Dams, Rivers and People made a submission to the project validators, TuV Nord. This included claims that the project developers were violating the CDM norms for consulting stakeholders and local groups, that the project was not additional and that the design document contained shockingly misleading statements which denied there would be any negative impact on the environment¹². Again, despite these serious allegations the validators requested registration in October 2006 and the project has now been approved.

¹⁰ www.irn.org/programs/greenhouse/index.php?id=050823xiaogushan.html

¹¹ “Letters to the editor: UN panel deceived over carbon credits” 13 February 2007

<http://search.ft.com/ftArticle?queryText=un+panel+deceived+over+carbon+credits&aje=true&id=070213000683>

¹² www.irn.org/programs/greenhouse/index.php?id=060711himanshu.html