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DIRECTORATE-GENERAL ENVIRONMENT
Directorate A - General and international affairs
ENV.A.2 - Climate Change

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**INTERIM REPORT:
ECCP WORKING GROUP 1 “FLEXIBLE MECHANISMS”**

1. Mandate and composition

The mandate of the Group is to examine how flexible mechanisms might be further developed within the EU in the context of climate change policy. The Working Group is to concentrate on the possible development of an EC-wide framework for emissions trading and the necessary regulatory framework. This includes examination of the methodology for the fixing of objectives for participating companies, and examination of the inter-linkages with environmental negotiated agreements, and other regulations and policies and measures.

A list of members of the Working Group, and their alternates, is attached as Annex 1.

2. State of play

Working Group 1 has met 4 times since being established. The meetings provided a fruitful forum for discussion of some of the more technical issues related to flexible mechanisms. The name of this Working Group implies that the scope of its mandate covers ways of providing greater flexibility in the achievement of the commitments arising from the Kyoto Protocol. Such “flexible mechanisms” as are covered by the Group are not just those referred to as the “Kyoto mechanisms”, but include instruments through which pre-determined environmental outcomes might be reached at lower cost (such as negotiated agreements). The instruments discussed so far have been primarily emissions trading and negotiated agreements. Furthermore, attention has been focussed on developments at national and EU level, rather than at international level – though the international context is relevant. It is not the Group’s purpose or intention to duplicate work being done in other fora on the project mechanisms of the Kyoto Protocol, namely Joint Implementation and the Clean Development Mechanism. Use of credit-based mechanisms will be looked at more closely after the Sixth Conference of the Parties to the UN Framework Convention on Climate Change (“COP6”), which will take place in November 2000. It is recognised that the outcome of COP6 is likely to influence the future work of this Group.

The Group has enjoyed a high degree of continuity of participants. Furthermore, the expertise of the members has contributed to an extremely high quality of debate on what are, after all, essentially complex technical issues that will confront any policy initiatives

in this area. The Chairman is grateful to the members for their high degree of commitment to this exercise.

Working Group 1 is rather different from other Working Groups. Primarily because, rather than trying to identify and quantify measures that could be taken, the Group is concentrating on issues and choices that will have to be made in order to use such flexible mechanisms within the Community as well as in individual Member States. The deliberations of the Group do not prejudice the Commission's right of initiative, but they assist the Commission by deepening the discussion with the range of stakeholders that are represented within the Group. The Commission is also able to benefit from the experience of members of the Group who are already involved in the development of flexible instruments. In conversing with each other, stakeholders are better placed to understand the concerns of others in approaching these instruments.

3. Subjects covered

Two presentations have been made to the Group. The first of these was by Mr Brian McLEAN from the US Environmental Protection Agency on the experience of sulphur dioxide and NO_x emissions allowance trading within the United States. The second, by Mr Peter ZAPFEL (European Commission, DG Environment), detailed the economic analysis results that were contained in Annex 1 of the Commission's "Green Paper on emissions trading within the European Union" (COM(2000)87 dated 08.03.2000). These presentations were for information only. However, the stimulus that they provided for the discussion amongst participants was appreciated.

To facilitate the discussions within the Group, the Chairman has prepared Background Documents for each meeting on the following subjects:

- (1) Objective setting in the context of emissions trading and negotiated agreements;
- (2) Allocation methodologies and recognition of early action;
- (3) Fair competition and internal market issues;
- (4) International macroeconomic competitiveness and flexible mechanisms.

These documents have been prepared initially under the Chairman's responsibility. The views expressed in these documents are then debated by the Group as a whole, and changes are subsequently made to the document that try to capture whatever consensus has been found within the Group. On some issues diverging views among the different stakeholders persist. If such differences of opinion cannot be resolved by the end of this process, the final report will acknowledge these.

The Group has raised and sought to clarify significant issues without necessarily reaching consensus on all points. These include:

- the certainty of delivering emissions reductions by absolute caps compared with relative, or "specific", targets;
- the merits of auctioning as an allocation method;
- the implications for state aid compatibility of various allocation methodologies, in particular of free allocation through grandfathering;

- and the impact of emissions trading on international business competitiveness;
- how to achieve compatibility with the developing international context for emissions trading.

Positions on none of these subjects have been in any way “finalised”, but the process of their consideration has been constructive. The Background Documents, although representing work still in progress, are attached to this Interim Report for information, along with the records of the first three meetings. All of these documents are public documents that Working Group members are encouraged to discuss within their own constituencies.

4. Economic Assessment

The economic analysis, as presented by Mr ZAPFEL and used in the Green Paper, showed that complying with the Kyoto Protocol’s objectives will cost the EU in the region of € 9 billion *per annum* without emissions trading across the EU. These costs are likely to be higher if Member States do not manage to optimise their strategies to minimise the costs of their compliance.

This analysis shows that emissions trading at EU level will reduce the costs of compliance with the Kyoto Protocol’s commitments. With the trading of CO₂ emissions across the EU by the sectors identified in the Green Paper, the cost savings are estimated to be at least € 2.1 billion *per annum*. As detailed in Annex 1 of the Green Paper, if all sectors participated in emissions trading within the EU, compliance costs would reduce to around € 6 billion *per annum*, which is a saving of approximately € 3 billion *per annum* compared to there being no EU trading. The same analysis also shows that extending emissions trading to all Annex B Parties would save a total of at least € 4.2 billion *per annum* compared to there being no trading. Increasing the number of gases traded, while not specifically analysed in the Green Paper, would in all likelihood further reduce the costs of compliance, but may raise new challenges with regards to the monitoring and verification of emissions. These issues should be further analysed.

The analysis presented, acknowledging the limitations of model-based economic analysis, shows that emissions trading at European and at international level would allow substantial economic benefits. Furthermore, emissions trading within Member States would deliver significant cost savings and efficiency improvements compared with a flat-rate reduction across all sectors.

5. Preliminary conclusions & assessment of likely features

Attention is drawn to the following preliminary conclusions.

Emissions trading is a means to deliver environmental targets in an economically effective way. Trading of emissions allowances by itself does not reduce emissions. The Group felt that emissions trading, if properly designed and implemented, can significantly reduce the adjustment costs of meeting the Kyoto Protocol’s commitments. Clearly, emissions trading can and should co-exist with other policies and measures.

On objective setting in the context of both emissions trading and negotiated agreements, it was concluded that it is possible that relative targets can be made to be as demanding as absolute targets, depending on the level at which they are set and on the circumstances of

the industry concerned. However, to be made compatible with emissions trading under the Kyoto Protocol, relative targets will have to be converted into a number of tonnes in absolute terms. Such conversion can only be done with certainty *ex-post*, once output is known. Absolute targets denominated in tonnes of CO₂-equivalent are directly related to Parties' assigned amount under the Kyoto Protocol. This reduces the risk to Parties of allowing entities direct access to the Protocol's international market. However, if the nature of targets does not maintain that direct relationship, then Governments may wish to restrict access to these international markets. Much will depend upon the willingness of Member States to accept the risk that the sale of allowances may not be backed by absolute emissions reductions.

On allocation methodologies it was agreed that all methods of allocation have potential advantages and disadvantages. The free allocation method that is probably most favourable to early actors, namely "grandfathering" with benchmarks, is more complex than other methods. Consequently, a mixture of allocation methods may be the most practical way forward in terms of reaching consensus. Furthermore, a progressive evolution towards auctioning is expected over the longer-term. There will have to be trade-offs between simplicity, transparency and equity.

The impact on competitiveness *vis-à-vis* third countries of reaching a pre-determined result is no more, and indeed potentially much less, with emissions trading than without. The impact of emissions trading on fair competition within the EU is also to be seen in the context of other policies and measures and *their* impact on fair competition. Emissions trading within the EU is, after all, just another policy and measure.

6. Intentions for future work

The Group intends to continue its work along the lines that have been adopted to date. Immediately after COP6, members will be up-dated (by a presentation) and debate the outcome of the UN negotiations. In addition to consideration of emissions trading and negotiated agreements, attention will also be given to Joint Implementation and the Clean Development Mechanism. Lessons will also be drawn from existing and developing initiatives in the context of flexible mechanisms. The issues identified in Section 3 will be re-visited as appropriate. A further six meetings are foreseen leading up to the adoption of the final report in May 2001.

This Interim Report was agreed by members of Working Group 1 at its meeting of 25 October 2000.

Peter VIS
Principal Administrator
Secretary to Working Group 1

ECCP WORKING GROUP 1
LIST OF MEMBERS

Name	Representing	Address	Telephone	E-mail
COMMISSION:				
Chairman: Mr Jos DELBEKE (Alternate: Ms Marianne WENNING)	DG ENV.A2	European Commission, 200, Wetstraat, B-1049 BRUSSELS	+32.2.296.88.04 (Alternate: +32.2.295.59.43)	Jos.delbeke@cec.eu.int (Alternate: Marianne.Wenning@cec.eu.int)
Secretary: Mr Peter VIS (Alternate: Marco LOPRIENO)	DG ENV.A2	European Commission, 200, Wetstraat, B-1049 BRUSSELS	+32.2.295.89.00 (Alternate: +32.2.296.86.78)	Peter.vis@cec.eu.int (Alternate: Marco.Loprieno@cec.eu.int)
Mr Marc VANHEUKELEN (Alternates: Mr Peter ZAPFEL & Mr Matti VAINIO)	DG ENV.B2	European Commission, 200, Wetstraat, B-1049 BRUSSELS	+32.2.299.34.05 (Alternates: +32.2.295.91.95 & +32.2.299.61.38)	Marc.vanheukelen@cec.eu.int (Alternates: Peter.Zapfel@cec.eu.int & Matti.Vainio@cec.eu.int)
Mr Stefan LORENZ-MEYER (Alternate: Mr Norbert THEIHS)	DG ENTR	European Commission, 200, Wetstraat, B-1049 BRUSSELS	+32.2.299.32.77 (Alternate: +32.2.295.04.10)	Stefan.Lorenz-Meyer@cec.eu.int (Alternate: Norbert.Theis@cec.eu.int)
Mr Mark HAYDEN (Alternate: Mr Manfred BERGMANN)	DG ECFIN	European Commission, 200, Wetstraat, B-1049 BRUSSELS	+32.2.299.34.18 (Alternate: +32.2.299.34.79)	Mark.hayden@cec.eu.int (Alternate: Manfred.Bergmann@cec.eu.int)
Mr Hans VON SCHOLZ – for emissions trading (Alternate: Mr Jamie GARCIA RODRIGUEZ Y ALVAREZ – for JI and CDM)	DG TREN.A3	European Commission, 200, Wetstraat, B-1049 BRUSSELS	+32.2.295.72.34 (Alternate: +32.2.295.99.53)	Hans-Eike.VON-SCHOLZ@cec.eu.int (Alternate: Jamie.Garcia@cec.eu.int)
NATIONAL EXPERTS:				
Ms Gertraud WOLLANSKY (Alternate: Mr Dieter BEISTEINER)	AUSTRIA	Stubenbastei 5 1010 Vienna Austria	+43 1 51522 1751	Gertraud.wollansky@bmu.gv.at (Alternate: Dieter.Beisteiner@bmu.gv.at)

Mr Dominique BUREAU (Alternate: (1) Mr. Jean-Jacques BECKER or (2) Ms Sylviane GASTALDO)	FRANCE	Department of Environment (Alternate: (1) Ministry of Economics, Finance and Industry or (2) Ministry of Environment)	+33 1 42 19 20 60 (Alternate: (1) +33 1 42 75 87 14 or (2) 33 1 42 19 25 16)	Dominique.bureau@environnement.gouv.fr (Alternate: (1) Jean-Jacques.becker@dp.finances.gouv.fr or (2) sylviane.gastaldo@environnement.gouv.fr)
Mr Franz-Joseph SCHAFFHAUSEN (Alternates: Dr Enno HARDERS & Dr. Andreas BURGER)	GERMANY	Federal Ministry for the Environment, Nature Conservation and Nuclear Safety Alexanderplatz 6 D-11055 BERLIN & 2 nd alternate: Umweltbundesamt Bismarckplatz 1 D-14193 BERLIN)	2 nd Alternate: Tel. +49 30 8903 2144 Fax +49 30 8903 2285	Schafhausen.FranzJ@bmu.de (Alternates: Harders.Enno@bmu.de &)
Mr Niklas JOHANSSON (Alternate: Åsa LEANDER)	SWEDEN	Swedish National Energy Administration P.O Box 310 S-631 04 Eskilstuna SWEDEN	+46 16 544 2139 (Alternate: +46 16 544 2262)	niklas.johansson@stem.se (Alternate: asa.leander@stem.se)
Mr Ian COATES (Alternate: Ms Jo SIMONS)	UK	DETR Global Atmosphere Division 3/F1 Ashdown House 123 Victoria Street London SW1E 6DE		Ian_Coates@detr.gsi.gov.uk (Alternate: Jo_Simons@detr.gsi.gov.uk)
INDUSTRY:				
Mr Jean-Yves CANEILL (Alternate: Ms Rose DE LANNOY)	EURELECTRIC	Electricité de France 6 Quai Walter B.P. 49 FR-78401 CHATOU CEDEX (Alternate: ELECTRABEL S.A. Boulevard du Régent 8, B-1000 Brussels)	+ 33 1 30 87 79 60 (Alternate: +32-2 501 2610)	jean-yves.caneill@edf.fr (Alternate: rose.delannoy@electrabel.be)

Dr. Klaus MITTELBACH (Alternate Dr. Dr. Joachim HEIN)	BDI	Abt. Umweltpolitik, Haus der Deutschen Wirtschaft, Breite Strasse 29, 10178 Berlin, Germany.	+49 30 2028 –1582 (Alternate: +49 30 2028 –1555)	k.mittelbach@bdi-online.de (Alternate: j.hein@bdi-online.de)
Mr Chris BOYD (Alternate: Dr Mike WRIGLESWORTH)	ERT (Alternate: UNICE)	LAFARGE 61, Rue des Belles Feuilles B.P.40, F-75782 PARIS CEDEX 16 (Alternate: BP Europe, Les Quatre Bras, 455 Ch. De Malines, B-1950 KRAAINEM)	+33 1 44 34 12 41 (Alternate: +32-2-766 3314)	chris.boyd@lafarge-e-groupe.lafarge.com (Alternate: Wriglemj@bp.com)
Mr Bertil HEERINK (Alternate: Mr Francesco BALOCCO)	European Chemical Industry Council (Alternate: International Federation of Industrial Energy Consumers)	Av. E. Van Nieuwenhuysse 4, bte 1 1160 Brussels (Alternate: DOW EUROPE Bachtobelstrasse 3, CH-8810 HORGEN)	telephone: +32.2.676 7267 (Alternate: +41 1 728 32 37)	bhe@cefic.be (Alternate: fbalocco@dow.com)
Dr Bill KYTE (Alternate: Ms Margaret MOGFORD)	“Emissions Trading Group” UK	Powergen Westwood Way, COVENTRY CV4 8LG, UK (Alternate: BG plc)	+44	Dr-William-Kyte@pgen.com (Alternate: margaret.mogford@bg-group.com & etgsecretariat@bciplc.com)
ENVIRONMENT NGOs				
Mr Rob BRADLEY (Alternate: Ms Karla SCHOETERS)	Climate Network Europe	42-44 rue du Taciturne, Brussels 1000 Belgium	+32 2 231 0180	rob@climnet.org (Alternate: karla@climnet.org)
Mr Mark KENBER (Alternate: Mr Stephan SINGER)	World Wildlife Fund	62 Shaftesbury Road Brighton BN1 4NF East Sussex, UK	+44-1273-676477 (Alternate: 32 2 743 8817)	mkenber@netscaponline.co.uk (Alternate: Singer@wwf.de)
Mr Jürgen LEFEVERE (Alternate: Ms Farhana YAMIN)	Foundation for International Environmental Law and Development		+44-207 637 7950 (Alternate: +44-207 637 7950)	jl44@soas.ac.uk (Alternate: FNYAMIN@aol.com)