Final Report of the 4th meeting
of the ECCP working group on emissions trading
on the review of the EU ETS

on

Linking with emissions trading schemes of third countries

14 – 15 June 2007

Management Centre Europe, Rue de l'Aqueduc 118, 1050 Brussels

- First day –

Agenda Item 0: Welcome and introduction

The Chairman, Mr Jos Delbeke (European Commission) welcomed participants.

Agenda Item 1-2: *A parliamentarian view and introducing to linking*

Mr ***Anders Wijkman*** (European Parliament) shared insights of his parliamentarian work relating to tackling climate change and commented on key important issues for the development of a global carbon market. He highlighted in particular that the global carbon market needed to be established step-by-step by everyone working together on this project taking due account of the experience that exists already in developing the EU ETS. In particular he stressed that for linking emissions trading schemes the schemes must be relatively similar, have mandatory caps and have robust monitoring and verification rules. Furthermore, he noted that it is necessary to address the issue of costs abatement in an equitable manner. On a more general note rules that limit the use of Kyoto credits, such as the supplementarity rule, would be important for the European Parliament and should be retained in the further review process. CCS should be considered in the further review process. He advocated that action was needed to avoid deforestation in developing countries but was not sure that the EU emissions trading system was the instrument for this.

In his presentation, Mr ***Simon Marr*** (COM) set out a general overview of the opportunities and challenges for linking emissions trading schemes. For linking emissions trading schemes lessons from the EU ETS Phase I should be taken into account. This includes keeping any emissions trading scheme environmentally effective by keeping a simple design, having a robust data basis for allocation as well as robust and stringent monitoring and compliance provisions in place and avoiding governmental interference in the market.

Mr ***Eric Haites*** (Margaree Consultants) gave an overview of the different types of linking and stressed that environmental effectiveness of linking emissions trading schemes can be reduced by various factors, including weak enforcement, a price cap, lower standards for offset credits, different rules on borrowing and banking. He highlighted that schemes' rules should converge and once they are linked it is important that the link is sustained, in particular by conducting comparable changes to the schemes, if necessary.

Agenda Item 3: Evolving emissions trading concepts in other parts of the world and their potential for linking with the EU ETS

Mrs ***Vicky Arroyo*** (Pew Centre) filled the audience in on the various state and regional programs underway in the US, as well as various federal legislation proposals and their implications on linking. She explained that whilst linkages were being considered in the development of these programs, they were never a top priority and linkage provisions were often less detailed than other aspects of bills. In some cases, explicit restrictions on linking were even in place. However, she stressed that although linking might not be a priority initially, it could nevertheless be brought in at a later stage. In any case, communication would be important.

Mr ***Toru Morutomi*** (Kyoto School of Government & Graduate School of Economics) outlined both the significance and limitations of the Japanese Voluntary Emissions Trading System by pointing out that whilst it allowed for the establishment of an institutional foundation for future full-scale mandatory ETS and the development of guidelines for monitoring and reporting, an emissions control system and electronic registry system, it was not positioned as an official policy instrument in Japan's climate change policy and not compatible with the polluter-pays principle.

Mr ***Leif Ervik*** (Finnish Ministry for Economics) gave a presentation on ETS Partnerships and explained that Joint ECS systems had the potential to play a dominant role in the fight against climate change and that up to 90% of all GHG could be covered. The same carbon price in all countries and sectors was a good basis efficient climate policy since it allows for as many countries as possible to join. At the same time, he emphasised that it was the Cap and only the Cap, which determines the actual effect on the climate. Thus it is vital that any system should have an appropriate level of scarcity.

Discussions (part 1)

The debate showed that it is still early to be discussing the issue of full-fledged linking. There is no precedent to follow in this case, which makes the determining of details more challenging. A number of stakeholders addressed the environmental effectiveness argument, as well as the economic benefit of linking emissions trading systems. While representatives of the carbon trading sector were in favour of full market effectiveness through depoliticising of cap setting, representatives from the energy intensive industry welcomed the possibility of cost effective reductions through investment in JI/CDM projects which was described as a form of linking in its own right and a certain degree of flexibility when linking the EU ETS with other schemes.

Agenda item 4: Compliance and Enforcement Issues in Relation to Expansion of the EU ETS Key elements for linking the EU ETS with third countries' emissions trading schemes (part 1)

In her presentation, Ms ***Barbara Buchner*** (IEA) set out the economic perspective of linking and identified where differences in design of different emissions trading schemes affect results of linking. She noted the importance to distinguish between design differences of

different emissions trading schemes and resulting accounting problems and the issue of linking itself. She highlighted that one needs to look at cost-abatement opportunity measures in the different schemes, if schemes should be linked. According to her the basic economic advantages of linking is to reduce overall compliance costs and reduce volatility of the market price of allowances. However, the extent of the reduction potential depends on the comparability of the design features of different schemed. To this end key design features include comparable tradable units, stringent monitoring, compliance and accounting rules to avoid double counting. Coverage of the scheme should be as precise and complete as possible, also as a means to ease competitive concerns. She concluded that it is possible to link systems even with very different design features by way of proper accounting methodologies or the use of a gateway which could, however, diminish the economic benefits achieved by lining.

Mr ***Jeroen Kruijd*** (PWC) emphasised the importance of building trust in emissions reporting. In order to build trust, one would need to ensure transparency, accountability and integrity with what he calls "a global emissions compliance language". He suggested that at least four elements be in place: A new, global institutional framework with local mirroring in which the public parties organise private markets; well developed, transparent and aligned compliance processes; a four-tier model for monitoring, reporting, verification and compliance standards and enhanced use for enabling technologies.

Mrs ***M.J. Mace*** (FIELD) discussed the legal issues on linking emissions trading schemes by analysing both legal and organisational issues which might arise from linking the EU ETS with other trading schemes. She concluded that different kinds of agreements would be needed in order to link with different partners and on different levels. Moreover, the time frame would be decisive in determining the structure of the agreement and one would have to bear the differences in ambition and design elements of a scheme in mind, since these might increase the complexity of the linking agreement. According to her the EU legislative framework could be amended to give the needed flexibility.

In his presentation, Mr ***Albert de Haan*** (ECX) demonstrated what linking the EU ETS with other trading schemes could mean for the carbon market. A true carbon price could only be achieved in a liquid market and linking would only strengthen the EU's leading role. However, Mr Haan emphasized that linking would only make sense if schemes were harmonised in order to enable trading. In his opinion, CERs could play the role of a global currency, but regulatory support with regards to ITL and eligibility criteria, for example, would be needed in order for it to function properly. In conclusion, Mr de Haan also noted the EU ETS's positive image within the US.

Mrs ***Jill Duggan*** (DEFRA, UK) gave an overview of the UK thinking on linking emissions trading schemes and also noted the importance for the international cooperation of linking. She stressed the proliferation of different emerging emissions trading schemes also in countries that have not ratified the Kyoto Protocol and suggested that in order to be able to link with such schemes the Directive should be amended to ensure confidence and environmental credibility in the system by ensuring scarcity and economic efficiency. In addition, she noted the need for a mechanism to assess whether a system is appropriate to link with, taking into account the need for either a bilateral linking or multilateral linking arrangement. Moreover, she advised that the review process should take into account how third parties look at trading in order to render linkages with the EU ETS more feasible.

Mrs ***Helle Juhler-Kristoffersen*** (BUSINESSEUROPE) stressed that getting the right price for Greenhouse Gas (GHG) emissions is what industry needs, because this is the foundation of a cost effective climate change policy. Therefore global expansion of the GHG market is necessary. According to her, linkage is a means to expand the global GHG market and create a level playing field for companies. BUSINESSEUROPE is therefore interested in expanding the market for GHG. But it is the expectation that regional trading schemes will be very different from the EU ETS on numerous areas. Therefore JI and CDM credits will be the short and medium term way of linking the regional schemes. At present, it is therefore imperative to improve the JI and CDM system. A number of barriers need to be removed.. One barrier according to BUSINESSEUROPE is the restrictions on companies' access to JI and CDM credits.

Mr ***Jean-Marie Chandelle*** (Alliance of Energy Intensive Industries) emphasised that the future scheme should both capitalise on EU experience and lead to cost-effective CO2 reduction, whilst preserving and ensuring competitiveness of EU Energy Intensive Industries. He also noted some criteria, which should followed: It should be open and avoid leakage of EU production, provide long-term predictability and safety for investments, allow for economic growth and meet society's needs, allow for specific reduction objectives by making use of technological potential, be a driver for cost-efficient solutions and innovation and be compatible with JI/CDM schemes and abstain from setting limits on these.

Mr ***Sanjeev Kumar*** (WWF) stressed the importance to first make the EU ETS work before any linking can happen and the fact that linking must not undermine the environmental effectiveness of the EU ETS and moreover, the ambitious long term CO2 reduction targets of the EU as have been concluded in this year's Council energy package. To this end he stressed that as a prerequisite to linking the EU ETS with any third emissions trading scheme there is a need for a similar level of CO2 reduction commitment.

Discussions (part 2)

In the debate, stakeholders stressed the role of JI and CDM for creating links in the common carbon market. Some industry representatives and some member states placed emphasis on JI and CDM credits maintaining value after 2012, no matter what follows the Kyoto-protocol. If greater certainty is not given, in their view JI and CDM activities will slow down. Emphasis was put on the importance of linking schemes that are mature enough and have proved their stability, and the compatibility with the continued acceptance of JI/CDM credits. In addition, stakeholders stressed that when linking the EU ETS with third country schemes, instruments need to be found to ensure a level of flexibility. Some Member States explicitly asked what kind of policy instruments would be needed in the future to deal with possible linkages to other international schemes. The question was also posed what role the EU institutions would play on a global stage.

Concluding Remarks by the Chair

Following the debate, the chairman drew the following conclusions:

1. With regards to the openness of the EU ETS, it was vital to ensure the transparency of and trust in the CDM. This was in place as an instrument under the Kyoto Protocol, and provisions would be required for appropriate recognition in the next phase to provide

investors and stakeholders with a greater degree of security and predictability in case no Kyoto successor agreement were yet concluded.

2. It is important to have internal harmonisation of the EU ETS as wide as possible as a step towards having external linking happen.
3. However, this should not delay long-term efforts towards future linking of trading systems. An element of caution should be preserved and a pilot period of reflection could be wise for any third emissions trading scheme before linking it with the EU ETS. For the same reason, against the background of the proliferation of various systems some flexibility is needed for linking the EU ETS with such systems. Working together along with harmonisation efforts at this stage will certainly simplify the process of linking at a later stage. Cost effectiveness will be an important driver towards the eventual linking of systems.
4. Winners and losers should not be determined at this stage in the process. It is less a question of Member States than it is one of companies, and one must bear in mind that boundaries between the winners and the losers are often indeterminable.
5. Simplification of compatible building blocks, such as common standards to build up for monitoring, verification and compliance in general can be crucial for linking and reassurance of each others' systems.
6. Building trust in linking is crucial in order to guarantee the functioning of the system at a later stage. Ensuring that the right key design elements of any linked emissions trading scheme, in particular as regards cap-setting and appropriate provisions on offsets, are in place and that these are compatible with the EU ETS will guarantee greater confidence in linking.

- Second Day -

Agenda Item 6: linking the EU ETS to the flexible mechanisms (JI and CDM) of the Kyoto Protocol – opportunities and pitfalls

The morning session started off with a presentation by ***Mr Thomas Bernheim*** (COM) who outlined briefly the current rules and procedures for use of JI/CDM by installations falling under the EU ETS, and pointed out opportunities and challenges they bring along. The presentation set out some questions for the debate with stakeholders, raising the issues of dealing with uncertainty in the status of JI/CDM after 2012, the potential future broadening of the scope of flexible mechanisms to include sectoral and policy CDM and what quantitative and qualitative restrictions could be needed in order to safeguard the environmental credibility of the project mechanisms in the context of a global carbon market.

In his presentation on the status of development of JI and CDM markets, ***Mr Joergen Fenhann*** (UNEP Risoe centre) gave an overview of the market in carbon credits generated by project mechanisms, with a country and sectoral breakdown of projects. He also discussed the implications of track I JI, which according to his research constitutes 61% of the 170 JI projects.

Mr Pedro Barata (Centre for Clean Air Policy) presented the concept of broadening the scope of flexible mechanisms by introducing extended CDM (programmatic, sectoral and policy) and sectoral no-loose targets. Each has certain merits but also generate problems of their own that need to be addressed. Specific methodological issues concern the setting of baselines and the availability of appropriate data. Also the additionality checks would in some cases remain problematic, even with use of sectoral baselines. Finally the institutional set-up of the CDM (Executive Board) may have to be changed to accommodate for the new types of offset mechanisms. As a way forward, he emphasized the need for more pilot projects in various sectors and regions to be developed to learn about the difficulties and opportunities of setting baselines and determining additionality.

Ms Kate Hampton (ECIS) emphasized the need for CDM to be seen as a tool to both reduce compliance costs (especially for exposed sectors) and to stimulate actions in developing countries. The review needed to address the continuation of fungibility after 2012 for projects initiated before 2012 and more visibility should be given on banking for CERs/ERUs under the ETS. She emphasized there was a need to go beyond offsetting in developing countries and develop mechanisms to help finance sector-wide policies (e.g. sectoral and policy CDM). She acknowledged the potential dichotomy between cheap reduction credits and the need for Europe to change technologies. One point of criticism related to the financial additionality checks for CDM which in her view hindered the bringing to the market of many negative-cost energy efficiency projects. In her final recommendations, she recommended that in reaching an international agreement according to which the EU commits to a 30% reduction target, such an agreement should include sectoral crediting and policy co-financing.

Agenda Item 7: Quantitative limits: pros and cons of caps and supplementarity requirements

The presentation by ***Mr Jürgen Salay*** (COM) focused on the provisions in the ETS Directive, delineating the use of JI and CDM credits within the Community scheme supplemental to domestic actions. He gave an overview of the expected use of flexible mechanisms within the ETS in the 2nd trading period (individual MS' limits on JI/CDM credit imports amounting to 10-15% of the total cap) and an analysis of the 22 NAPs assessed so far, which that imports of 1110 Mt in JI/CDM credits would be allowed in total (of which companies based in the EU-15 MS could use up to 928 Mt). He pointed out that this represents a theoretical maximum and it is not certain that these limits will be reached. He pointed out that at present MS can accept at their discretion the amount of JI/CDM credits up to the maximum level allowed under the Linking Directive. For internal market considerations there was a desire in the future to go for a more harmonised approach towards JI/CDM limit setting (for example, through a flat rate from start, triggers or differentiated limits depending on type of JI/CDM credits). An important political consideration for capping the access to JI/CDM was to ensure attractiveness for other systems to link to the EU ETS.

Mr Guy Turner (New Carbon Finance) made a quantitative contribution to the analysis of supplementarity in the use of CDM/JI credits within the ETS. He commented that supplementarity results in higher price signals in the EU ETS than might otherwise be the case, and that this higher price is needed especially in the long turn to steer capital investment into low carbon technologies. In the period until 2012, short-term possibilities for emission reductions included fuel switching, including renewables, but over time capital stocks be only be changed if a long term price prevailed well above what the CDM would induce in the ETS . This in itself justified the use of supplementarity requirements. He also suggested that the secondary market for CDM closely follows the trend in allowance prices (however staying below the allowance price as a result of additionality requirements). This has led to a strong increase in primary project developments by industry and in energy sector, offering cheaper alternatives. Additionality could result in price volatility as there always will be arbitrage between allowance and CERs. A final conclusion was that the use of low-cost external credits in the ETS can help reduce the costs of compliance but will not help investment in carbon reducing projects within the ETS.

Mr Owen Wilson (Eurelectric) presented an overview of the pros and cons of a cap on the use of JI/CDM within the Community trading scheme. Negative impacts according to him predominated, and were expressed through discouraging long term investments and creating instability in the market among others. He called for more certainty about the CDM in a post 2012. If supplementarity rules were to be retained, there would be a need for more transparent and harmonised rules throughout the EU. The fact that in the EU formula for supplementarity, a priority was given to government purchases was seen as discriminatory against companies. There was no strong wish to link the EU ETS to other ETS if this would result in higher prices. Generally, industry was much keener on full use of (cheap) CDM rather than linking to other (more expensive) ETS systems.

In her presentation, ***Ms Vicki Arroyo*** (Pew Centre) noted that while there may be a general perception in other countries that the US was not willing to accept imports of CDM credits, CDM credits were however allowed in proposed US trading schemes. Some reservations were made concerning certain categories of credits. She acknowledged that the transfer to e.g. China of considerable amounts of money through the CDM was a political issue in the US. This was counterbalanced by the cost gains that would be generated by access to those cheaper credits. She questioned the use of land for offsets but proposed that they be replaced with best practices in farming and other similar schemes.

Ms Mahi Sidgeridou (Greenpeace) presented the views of NGOs on the use of CDM credits within the ETS. In her presentation, she underlined the lack of supplementarity and cases of bad quality of CDM projects. She made a case for an overhaul of the system based on the principles of environmental effectiveness on the grounds that the price impacts of a low cap should not go below the marginal green investment costs. More stringent caps would stimulate internal abatement in the EU, and were needed to achieve the 2050 abatement targets.

Agenda Item 8: Qualitative restrictions (gases, sectors and project types) on the use of offsets

Mr Lambert Schneider (Öko Institut) outlined the range of problems encountered in assessing the additionality of projects. He commented that there was no objective way to confirm that a project would not have been implemented without CDM. As no benchmark approach had yet been submitted to the CDM EB that would demonstrate additionality, CDM EB relies on a barrier analysis, investment analysis and common practice analysis. Amongst others, renewable energy projects are not always additional. CERs have, moreover, only small impact on the projects' internal rate of return (IRR), sometimes amounting to just 1–3%. While for some categories of projects this could make a difference, for others (e.g. wind farms) this is almost negligible. His personal assessment was that up to 30-50% of CDM projects could not be viewed as being additional. One of the solutions he proposed to stem windfall profits from some categories of CDM projects would be to introduce benchmarks

Mr Damien Meadows (COM) in his presentation noted that Member States were allowed and not obliged to authorise their companies to use JI/CDM and that a harmonised agreement only existed on not using certain types of credits. He suggested that there could be a need for a more harmonised approach towards qualitative restrictions on the use of JI/CDM, perhaps by stating that companies "shall be" be allowed to use such credits, rather than "may be". This was illustrated with respect to the use of nuclear, temporary (or delayed emission) credits, which both raised issues of governments taking on liability. A common approach could be applied where there have been widespread criticisms, for example, as regards HFC and hydropower credits. Such harmonisation could be done in several ways, e.g. through co-ordinated Member State action not to use certain credits, specific provisions set down now through co-decision or a mechanism for EU-wide action to be taken. He ended with some considerations on the transition beyond 2012, highlighting the potential need for flexibility to take into account the evolution of commitments expected in the post-2012 agreement. In the context where such an agreement were not yet in place, consideration was needed as to what credits should be used in the meantime, and by what process harmonised rights to use them could be granted. In respect of credits to which banking limitations under the Kyoto Protocol applied, he noted the need for provisions to avoid governments taken on liabilities. Finally, he queried whether there was merit in Community-level arrangements for authorising projects more broadly than allowed by the CDM.

Mr Andrei Marcu (IETA) pointed out that linking would lead to the emergence of larger (ultimately global) market, thus reducing costs of compliance and improving efficiency. GHG markets provide make or buy option. Not all countries are receptive to buying, notably the US is not enthusiastic on CDM, among others, resisting the idea of shipping capital offshore to deal with emissions and voicing concerns about environmental integrity of emissions trading as such. IETA agrees that actions against climate change should begin at home and offsets are

temporary mechanisms as the goal is to introduce global emissions trading. He also advocated setting up supplementarity rules at the EU level and allowing a broader range of projects as CDM.

Mr Dieter Beisteiner, (Austria) presented experience of a member state in JI/CDM project approval and procedures. Austria is one of the EU MS with an experience of financially supporting projects that would generate emission reductions abroad through the use of flexible mechanisms.

On LULUCF, ***Mr Igino Emmer*** (Climate neutral group) made a presentation on forestation credits. In his view tCERs should be included, but lCERs could not be for various reasons. The LULUCF sector could contribute to 30-40% of efforts in GHG reductions necessary to achieve the +2°C target. He acknowledged that people perceive LULUCF projects as risky business, as they introduce temporary credits. There are also fears about swamping the market with very cheap credits. However these problems could be overcome.

Mr Tomas Wyns (CAN Europe) insisted one shouldn't compare CERs with allowances (as this amounts to comparing apples with pears). He warned for the negative credibility consequences of including sink projects in the CDM. Instead the EU ETS should only allow credits that respected the gold standard (energy efficiency and renewable projects). Finally he called for the EU ETS to take sustainable development criteria more seriously and develop screening mechanism for projects entering the EU ETS. This could be done by adding a positive list of criteria to the CITL, allowing for an automatic check on the CERs type and provenance before accepting to register them for compliance within the EU ETS.

In a concluding remark, ***Mr Jos Delbeke*** (chair) stated that without supplementarity provisions CDM supply would most likely outstrip demand, so that their price would tumble. This could start a political debate about whether the EU ETS is capable at all of fulfilling its role of driver for technological change within the EU and instead mainly creates flows of money and investment outside the EU.

Discussions

In the course of the ensuing debate, MS representatives expressed their views on topics covered in the course of presentations. Member States expressed support for the idea of expanding emissions trading into a global regime, while some emphasised that in the meantime offset projects could play an important role for at least further 10 years. It was also proposed to discount CDM projects from some countries after a certain level of supply was reached. Some Member States supported including LULUCF credits in the ETS and discussing LULUCF at COP/MOP in Bali. It was said that the Commission should review the pros and cons of the project-based approach.

The Commission pointed out that double counting was also an issue influencing the environmental credibility of the system, thus the double counting guidelines will need to be maintained. In the current international situation, there is a large number of CERs on the market and the ETS should not be an engine for transferring reduction efforts abroad.

Ms Jill Duggan (UK) noted that to achieve a 50% emission reduction by 2050 declared by G-8 countries, the inflow of JI/CDM credits into the EU ETS must be limited. According to Mr Lambert Schneider, at current cap levels for JI/CDM in the period 2008-12, emissions from

the MS could be higher than in 2005. An assumption is needed that emissions will not grow. In Germany, for example, new lignite plants are planned, as EU ETS at present is clearly insufficient to promote alternatives to new lignite plants.

The participants considered various options of integrating project mechanisms into emission trading so as to foster European reduction efforts and not jeopardise the market. An idea was floated in the course of discussion of using a Community-level procedure for approving projects within the EU to also assess credibility of inflowing project credits. A positive list of criteria for promoting clearly additional types of CERs was also proposed.

Some industry representatives argued that all effort should be put into improving the UN system, e.g. improving the approval procedures, rather than developing parallel systems, EU specific standards and procedures which could increase complexity and reduce transparency.

Wrap-up of the second day

Summarising the meeting, ***Mr Delbeke*** stressed five points:

1. A wealth of information had been shared over the last two days. The current experience with CDM had been a success, with the engagement of developing countries. However, there had been concerns expressed that the size of the market could become so big (especially if there were extended CDM) that it may turn people against the CDM altogether. There were a number of flaws including, among other issues, doubts about the additionality of certain projects and the crowding-out effect of HFC projects which create problems of credibility that risked spilling over to the EU ETS. These need to be addressed.

2. Participants shared the common objective of a long term global carbon market. Linking emission trading systems will require time, and can build on the CDM as an intermediate step. For an effective market, there needs to be balance between supply and demand, In Marrakesh, it had been expected that there would be wider demand, which would b e the case with the US on board. In the current situation, the CDM could lead to an imbalance for the EU which would need to be addressed.

3. Ideally, the existing problems with the CDM will be remedied within the UNFCCC. This will involve developing benchmarks, and taking into account policy implementation. There is also a need to develop better criteria for showing additionality. Some stakeholders had called for a more fundamental rethink, while others said that we should look at the benefits of CDM to EU companies including as a stimulus for innovation, and that this should be assessed empirically.

4. If the problems identified with the CDM cannot be sufficiently well solved within the UNFCCC, then these problems would have to be addressed in the EU ETS. Views differed on quantity, where some said there should be no limit while others emphasised that quantitative provisions should be set at EU level. The issue of discounting was also raised. On quality, lists came back onto the table – both positive and negative. On nuclear, the Marrakesh Accords had so far been proving successful. There were outspoken views for and against the idea of an additional JI/CDM board and screening.

5. There was broad consensus that provisions on the use of JI/CDM should be dealt with in a harmonised manner. In addition, it was noted that this would strengthen the EU's position internationally. Problems should aim to be corrected within the UNFCCC, with solutions implemented at EU level if not successful. There was wide support for an assurance to be introduced that companies would definitely be able to use JI/CDM credits in the next period, even if people disagreed on which types.