WHITE & CASE
LIMITED LIABILITY PARTNERSHIP

EU Emissions Trading - facts, problems, JI/CDM linking

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http://www.eujapan.com/japan/home.html

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EU排出権取引
-現状, 問題点, JI/CDM linking

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1) FACTS

Background

- 1997 Kyoto Protocol: International Emissions Trading by 2008
- First emissions trading concept supported by US
- European Commission/Parliament: very critical – « license to pollute »
- 2000 Commission Green Paper
- Wide support for EU Trading scheme idea
- October 2001: proposal for a Directive
- July 2003: new Directive adopted by European Parliament and Council
- October 2003: entry into force / publication OJ
- By end 2003: implementation into national law

Scope

- 28 EU & EEA Member States
- More than 20 000 installations to be covered (4500 in Germany; 2000 in UK):
  - ✓ electricity and heat generation;
  - ✓ oil refineries;
  - ✓ coke ovens;
  - ✓ cement production;
  - ✓ ferrous metals production & processing;
  - ✓ glass manufacturing;
  - ✓ ceramic products (including bricks) manufacturing;
  - ✓ paper and pulp production.
- Only CO2

Scope (II)

- Directive to be reviewed by end 2004, and mid-2006
- New gases: CH_4, N_2O, HFCs, PFCs, SF_6
- New sectors:
  - ✓ Chemicals manufacturing;
  - ✓ Aluminium production;
  - ✓ Transport;
  - ✓ Waste incineration
- R&D installations are not covered
- Individual Member States can broaden scope
  - ➢ From 2008 after approval by Commission/other states
  - ➢ Should not distort competition/Single Market
  - ➢ If reliable monitoring available

Goals

- Emissions cuts where they can be made most cheaply
  - ⇒ 35% cost reduction / year; or € 1.3 bn / year
- Only set a regulatory framework
- Market forces to establish the market/exchange as such
- National and individual emissions caps should not hinder economic growth and development
- EU trading to start 1/1/2005

Nature of the scheme

« Cap and trade »

1) Apply for emission permit
2) Need to be capable to monitor and report emissions
3) National allocation plan
   - 2005-2007, 2008-2012, 2013-2017, etc.
   - Sets national cap, cap per installation
   - 1st one ready by 31/3/2004
   - To be approved by European Commission (comitology)
   - EC to develop guidance on how to draw up plans
   - ⇒ 5-year periods to lead to predictability/stability
4) Actual allocation 3 or 12 months before start of 3 or 5 year period – on basis of plan – public comment

Nature of the scheme (II)

5) Actual allowances will be issued by end February each year
6) Each installation to surrender allowances equal to emissions of preceding year (by 30/4 following year)
7) If installation emitted more than allowance => need to buy extra allowances
8) Not able to surrender enough allowances? Penalty!
9) Surrendered allowances will be cancelled

National allocation plan

Cornerstone of trading scheme!

- If national/company caps are set too high:
  - too easy to emit less than cap => too many allowances available for trading => oversupply means <u>lower price</u>
- If caps are set too low or too strict:
  - difficult to emit less than cap => higher demand for buying up allowances, and less allowances available for trading => not enough supply and high demand means <u>higher price</u>

⇒ Low price: 1) reduces financial value of reductions; 2) is disincentive for reductions because cheaper to buy

⇒ High price: 1) increases financial value of reductions; 2) is disincentive to buying allowances

National allocation plan (II)

Criteria govern national plans (Annex III) :

- Caps to be consistent with "achieving or over-achieving" national Kyoto target
- Take account of technological potential of activity (reduction technology available=>less allowances)
- Allowances must not be illegal state aid (no distortion)
- Plan must be able to deal with new entrants
- Early reduction companies not to be punished
- Comments from public/companies to be taken into account

Methods of allocation

-2005-2007: at least 95% free of charge allocation

-2008-2012: at least 90% free of charge

Only 5%/10% auctioning possible (but not mandatory)

- Free allocation on basis of historical levels (« grandfathering »)
  - EP: not in line with polluter pays principle
  - EP: but what is market prepared to pay for allowances??
  - EP: may discriminate against early reduction companies
- Auctioning
  - EC: may frighten companies off from participating fully
  - EC: difficult to regulate auctioning at this stage
- Mid-2006 review: what method for post-2012?

Exemptions

- Only companies/installations in a Member State can be exempt from trading, not entire industrial sectors
- European Commission can only grant approval until end 2007 if:
  - National policy has equivalent emission reduction effect;
  - National monitoring is of equivalent level;
  - National penalties are equally dissuasive;
  - Internal market is not distorted

✓ EP opposed exempting sectors

✓ EC opposed exemptions as such

2) PROBLEMS

NAP's submitted as of June 4

- 14 Final NAP's submitted (Germany, Finland, Ireland, Denmark, Austria, Luxembourg, Netherlands, Sweden, Slovenia, Lithuania, United Kingdom, Slovak Republic, Estonia, Latvia)
- 4 draft NAP's available (Portugal, Belgium, Italy, Czech Republic)
- 7 Member States: nothing yet…

=> Only 14 out of 25…

=> Spain: new government – start all over again…

=> Hungary, Greece, Italy: not final until September…

Final NAP must be adopted <u>by October 1, 2004</u>!

National Allocation Plans

31.3.04 deadline: EC three months to **reject NAP**

⇒*Member State can only adopt NAP if proposed amendments are accepted by EC…* (Art. 9.3)

- What if MS proposes NO amendments?
- What if MS proposes unacceptable amendments?
- What if it takes more than e.g. one year before MS comes up with acceptable amendments?
- Can such MS 'obstruction' be prevented?
- Will EC accept 'unacceptable' NAPs anyway to safeguard ETS and avoid massive distortion?

Role of committee?

Art 9.2: *NAPs shall be considered within Committee referred to in Art 23*

⇒**"comitology" committee** made up of national experts in climate change & ET

- Committee can only 'consider' NAPs – not approve or reject?
- Will this be forum where MSs will critically assess each others' NAPs?
- Will they be able to put 'peer pressure' on EC e.g. where a NAP is too lenient?
- What will be real role of committee?

Definition of combustion installation

- Inclusion in covered activities of « ***Combustion installations*** *with rated thermal input >20MW* » can bring in operators in sectors that are not targeted (e.g. car manufacturing, aluminium, etc)
- How do you define « Combustion installation »?
  - ⇒'everything that burns' (EC)?
  - ⇒Only installations for production of energy (UK)?
  - ⇒Only installations of energy producers (France)?
- Does EC intend to issue guidelines to avoid distortion of one MS including and others not??
  - -EC climate change unit official: *"Lot of work in committee on this problem. Don't think this will be huge discrepancy. "* (implied: EC may not start infringements for this…)
  - -Wallström: *"Trying to get a common interpretation among Member States"*

State Aid

« Allocation decisions shall be in accordance with Treaty Articles 87 & 88 » (Art 11.3) ⇒**State Aid**

- If a MS allocates more than installations need, is that an illegal subsidy??
  - ⇒ there must be a transfer of state resources
  - ⇒ EC will 'ex officio' examine NAPs on State Aid
  - ⇒ Companies can file complaint with DG Competition
  - ⇒ If DG Comp opens formal investigation: MS must STOP application of NAP (Art 88.3 Treaty)
- Or will EC be extra lenient in examining State Aid & NAP??
- Potential for competitive distortions is significant…

State Aid (II)

- Commissioner Wallström - beginning of March 2004:

  "By over-allocating Member States would deprive themselves of the tools they need to get on 'the path to Kyoto' as described by the directive. In this case, the Commission would have to act – and will act if necessary."

- EC climate change unit official - 27 April 2004:

  "But we need to make ET a success!"

- DG TREN official – 27 April 2004:

  "There is currently a lot of over-allocation, but this will lead to lower prices, so that's probably good."

State Aid (III)

- EC climate change unit official – 15 March 2004:

  "We can't cross compare sectors with other sectors in different Member States."

- Wallström – 18 May 2004:

  "Many NAPs go for a rather high quantity of allowances. This is disappointing. (…) This perceived lack of scarcity is reflected in carbon market price which has fallen significantly. (…) This will create little incentive to change behaviour."

- UK Environment Secretary Beckett:

  "EC should scrutinise thoroughly NAPs" (to avoid competitive distortions that may damage UK companies which face rather strict caps)

Recent developments

- May 18, 2004 – Wallström announces EC « is beginning preparations for infringement proceedings » against late Member States
- New MSs allowed further « grace period »
- EC sent letters to several MSs asking for clarification on perceived over-allocation or irregularities

=> Perceived over-allocation: Austria, Finland, Portugal, Germany, …

=> Over-achieving Kyoto goals: only UK, Sweden

The price of electricity/energy

- Because of ‘marginal cost pricing’ in the electricity market:
  => Price hikes of 10-15% in most national/regional markets

Result?

Low carbon generators (nuclear, hydro) will receive windfall profits without facing additional costs.

Problem?

Power-intensive industries expect to pay some €2400mio more per year

But…

EC says their suggested solution may take away price incentive for emission reduction

Various legal hurdles

- VAT and taxation – varies from country to country
- ‘simple’ barriers to trade
- National registries
- Allowances and insolvency

Example: German utility

- Runs a nuclear power plant which will have to be closed under German nuclear phase-out
- Will probably have to revert to fossil fuel electricity production to replace lost capacity
- Claims not enough allowances are foreseen to cover fuel switch
- Will lobby EC to reject this part of German NAP
- Will prepare legal challenge for German/EU courts should NAP be accepted as it is

Example: Japanse cement company

- Operates several manufacturing facilities in EU
- Has introduced already several years ago technology which has significantly reduced CO2 emissions
- Because allocations are based on average historic emissions: its plants will receive fairly low amount of allowances compared with competitors
- This means company is « punished » for early reduction action

=> Solutions? Lobby EC and MSs - Choose very early base period - other technical options possible

Example: Netherlands NAP

- Small companies (= emit < 25 000 ton/yr) will be exempt from NAP if they wish
- Government will rely to certain extent on purchasing JI/CDM allowances to achieve Kyoto target
- Allocations on basis of installations' average emissions for 2001 and 2002, but taking into account production growth estimates
- New entrant reserve to be allocated free of charge (=transfer of state resources, or state aid?)
- Part of that reserve will be used for increased allowances that will need to be allocated as a result of legal appeals

Example: UK NAP

- UK government does not intend to use JI/CDM
- UK should reduce 12.5%, but goes for 20% = over-achieve Kyoto! Allocations calculated on that basis
- Installations covered by existing UK ETS to be exempt
- Allocations sector level:
  - ⇒ Electricity generation required to deliver most of the overall reductions required (5.5 mio ton CO2)
  - ⇒ Other sectors projected emissions 2005-7
- Installation level: on basis of highest five of last six years
- New entrants reserve of 7.7% of total allowances free of charge

3) JOINT IMPLEMENTATION – CLEAN DEVELOPMENT MECHANISM

What is JI and CDM?

Established under the Kyoto Protocol as project based mechanisms:

Joint Implementation

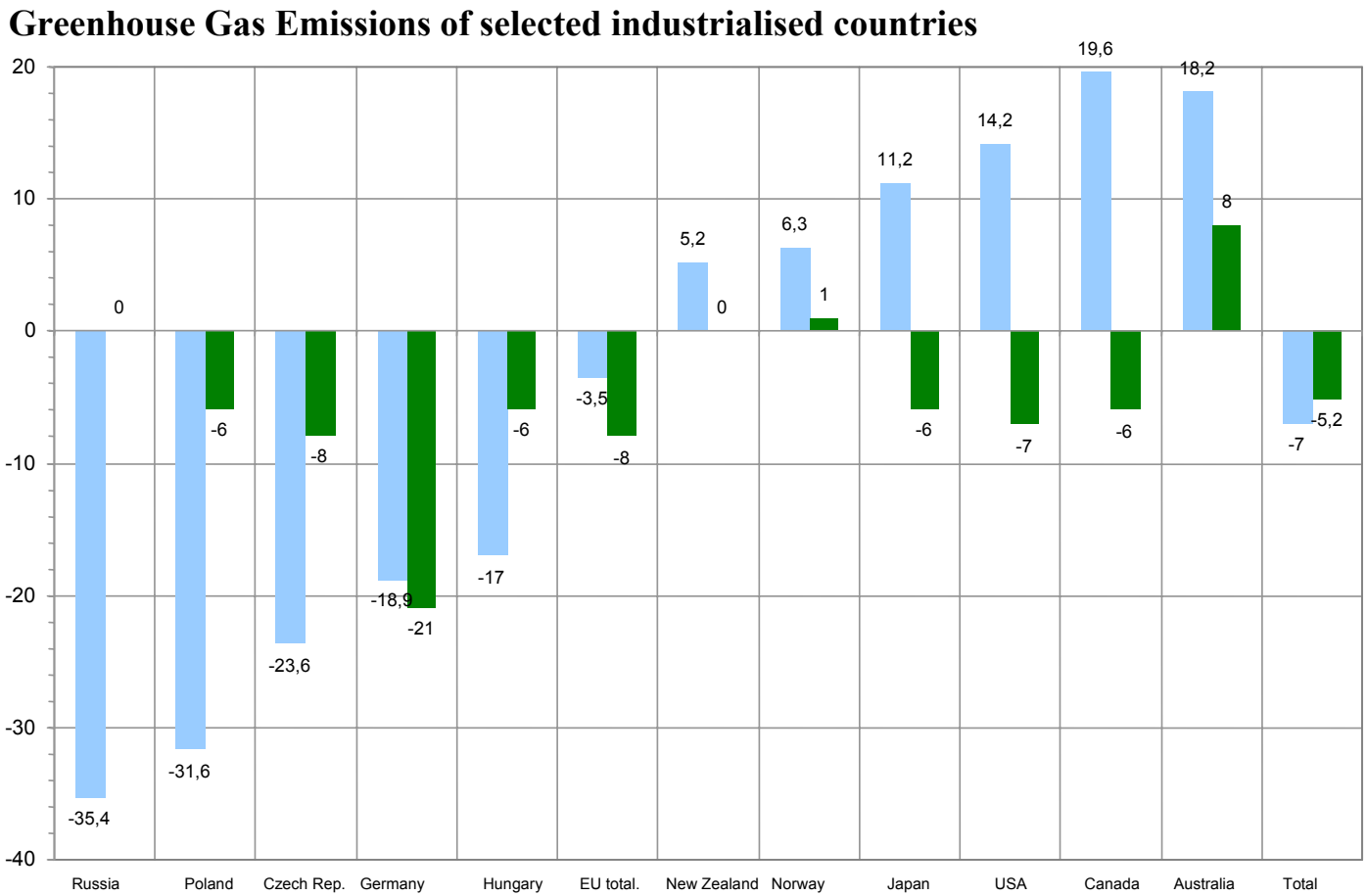
- Between developed and/or transition countries (Annex I Parties UNFCCC[1]) = countries with restricted emissions
- Emission Reduction Units (ERUs) issued by host country, transferred to investor country
- Not before 1/1/2008

Clean Development Mechanism

- With developing countries = don't have reduction targets
- Certified Emission Reductions (CERs) to be issued by CDM Executive Board (UNFCCC body)
- Guarantee that post-2000 and pre-2008 CDM projects will be accepted (KP Art. 12(10))

[1] United Nations Framework Convention on Climate Change

Joint Implementation



Situation in 2000 (Russia 1996) compared with 1990 (in %) / source UNFCCC

Kyoto target 2008/12 compared with 1990 (in %)

Kyoto background

- Kyoto aim: greenhouse gas emission reduction is good anywhere on the globe, as long as it happens!
- Regulated by Marrakech Accords (Nov 2001)
- Enable lower cost reductions in other countries
- Enable technology transfer to less developed states
- ‘credits’ generated through projects that reduce emissions in addition to what would have happened in the absence of the project (=baseline)
- No nuclear energy projects; no carbon sink projects
- Supplementary to domestic action (JI/CDM should not completely replace making maybe costly reductions at home!)

New JI/CDM linking directive

- July 2003 EC proposal: link JI/CDM with EU Emissions Trading
- April 20, 2004: EP adopts compromise with Council
- Formal publication and entry into force is imminent
- Main elements:
  - ✓ Member States to decide on maximum national % of allowances gained through JI/CDM
  - ✓ This maximum % is to be included in the NAP
  - ✓ No credits from nuclear, & carbon sinks (to be reviewed 2006)
  - ✓ Large hydroelectric projects only if they comply with international guidelines (World Commission on Dams, OECD)
  - ✓ Member States will have 12 months to implement into national law

New linking directive (II)

- ERUs and CERs to be converted into EU ETS allowances upon request by operator
  - ⇒ is in addition to allowances under national allocation plan
- Avoid double counting => an installation covered by ET scheme can NOT be elegible for JI projects
  - ⇒ Because it could receive NAP allowances and JI-ERUs for the same reduction…
  - ⇒ Unless the NAP allowances are cancelled
- Possibility for Member State to temporarily exclude an existing JI project from EU ET scheme

New linking directive (III)

- Expected to increase liquidity of allowance market, and lead to lower price per allowance

- Linking JI/CDM with Emissions Trading should allow installations covered to save €700mio/year
  - ⇒ estimated allowance price to be halved to €13

Until now, reluctance of private companies:

- ✓ uncertainty – entry into force Kyoto Protocol?
- ✓ risks associated with early JI & CDM
- ✓ lack of capacity in host countries to approve projects
- ✓ still high transaction costs

=> But governments can also be buyers (e.g. Dutch scheme, World Bank Prototype Carbon Fund)

Example

- White & Case is advising a Dutch company on a CDM project: construction and financing of a waste landfill in Ho Chi Minh City
- Should lead to reduction of methane (CH_4) emissions
- World Bank Prototype Carbon Fund will purchase emission reductions credits (CER's)
- Dutch government is a big 'shareholder' of the WB Prototype Carbon Fund
- Dutch government will receive its share of the purchased CER's
- This is still a-typical because of involvement of a national government as a purchaser