Legal Alert

DE BRAUW BLACKSTONE WESTBROEK

Changes to EU Emissions Trading Scheme

March 2009

This Legal Alert highlights the main elements of the directive amending Directive 2003/87/EC on the EU Emissions Trading Scheme (the "**New EU ETS Directive**"), which was adopted by the European Parliament on 17 December 2008 as part of the EU climate package. The climate package also comprised several other directives, including the Effort-Sharing Directive (on the shared emissions reduction effort of Member States) and the CCS Directive (on the geological storage of CO_2).

Background

The first compliance period of the EU ETS (Phase I) ran from 2005 to 2007. The current Phase II runs from 2008 to 2012, in parallel with the first commitment period under the Kyoto Protocol. The New EU ETS Directive provides that Phase III of the EU ETS will run from 2013 to 2020.

In March 2007, the European Council adopted the objective to reduce greenhouse gas ("**GHG**") emissions by 20% by 2020, as compared to 1990 levels. In addition, the Council endorsed an increased reduction objective of 30% by 2020 if other developed countries adopt comparable emissions reduction commitments and economically more advanced developing countries also contribute to emissions reduction in accordance to their responsibilities and respective capabilities.

Main changes and issues

The New EU ETS Directive reflects the EU's independent commitment to reduce its emissions to at least 20% below 1990 levels by 2020. If an international post-Kyoto agreement is reached which provides for mandatory emission reductions exceeding 20% by 2020 (as reflected in the 30% objective endorsed by the Council), the Commission will submit a legislative proposal to amend the New EU ETS Directive in line with such international agreement.

Cap and linear decrease

The Commission will publish the absolute quantity of allowances available for 2013 not later than 30 June 2010. The available annual quantity will decrease by a linear factor (of 1.74% compared to the average annual quantity for the period 2008-2012), to arrive at a reduction of 21% below reported 2005 emissions by 2020 (approximately 1.72 billion allowances).

The New EU ETS Directive provides for a new entrants reserve of 5% of the total quantity of EU allowances. Allowances from this reserve that are not allocated to new entrants during Phase III shall be auctioned by the Member States.

Auctioning and allocation free of charge

The basic principle for the allocation of allowances under the New EU ETS Directive is auctioning. Allowances for the electricity production sector will be fully auctioned from 2013 onwards, but allocation free of charge will be given for district heating and high-efficiency cogeneration in respect of heating and cooling. Member Sates may also grant transitional free allocation for modernisation of electricity generation.

A gradual transition will be applied to other sectors, starting with 80% allocation free of charge in 2013. This percentage is to be reduced by equal amounts each year, finally reaching 30% free allocation in 2020, with a view to reaching no free allocation in 2027.

By 31 December 2010, the Commission will publish the estimated number of allowances to be auctioned. The auctioning of allowances for Phase III should start by 2011. By 30 June 2010, the Commission will adopt an auctioning regulation on timing, administration and other aspects of auctioning.

88% of the total quantity of allowances that are to be auctioned will be distributed among Member States according to their emissions reported for 2005, or the average for the period 2005-2007 (whichever is higher). 10% will be distributed among certain Member States for the purpose of solidarity and growth, to reduce emissions and adapt to climate change. The last 2% of the allowances to be auctioned will be distributed among Member States whose GHG emissions in 2005 were at least 20% below their emission levels in the applicable base year under the Kyoto Protocol.

Member States may decide how to spend their revenues from the auctioning of the allowances, but at least 50% of the revenues should be used for certain policy objectives listed in the New EU ETS Directive, including reduction of GHG emissions, development of renewable energies, energy efficiency and low emission public transport.

Carbon leakage

Certain industry sectors may be induced to relocate GHG emitting activities from the EU to countries with less stringent emissions reduction policies, thus causing an increase in global emissions. To prevent such “carbon leakage”, the New EU ETS Directive provides for the possibility of allocating 100% allowances free of charge to certain energy-intensive sectors that are subject to international competition. The Commission will identify which sectors or sub-sectors are susceptible to carbon leakage by 31 December 2009 (which list will then be reviewed every five years). Further proposals on carbon leakage measures will be presented by 30 June 2010, based on an analysis report and the outcome of international negotiations.

Member States can also adopt financial measures in favour of sectors exposed to a significant risk of carbon leakage. Such support may only be granted if necessary and proportionate, in accordance with applicable state aid rules.

Exclusion of small installations

Member States may exclude small installations from the EU ETS if this improves the cost-effectiveness of their emissions reduction efforts. Small installations are defined as installations with reported annual emissions of less than 25,000 tonnes of CO_2-equivalent and (where they carry out combustion activities) a rated thermal input below 35 MW in the preceding 3 years (excluding emissions from biomass). Such small installations may be excluded from the New EU ETS Directive, provided that they are subject to other measures that will achieve equivalent emission reductions. Hospitals may also be excluded if they undertake equivalent measures.

Extended scope

The New EU ETS Directive extends the scope of the EU ETS to new sectors and gases, including GHG emissions from petrochemicals, ammonia and aluminium industry, as well as N_2O emissions from the production of nitric, adipic and glyoxalic acids and PFC emissions from the aluminium sector.

Carbon capture and storage

Installations for the environmentally safe capture, transport and geological storage of GHG are included in the New EU ETS. To provide the necessary incentives for geological storage of emissions, there will be no need to surrender allowances for emissions verified as captured and transported for permanent storage to a facility for which a permit is in force in accordance with the CCS Directive. Up to 300 million allowances from the new entrants reserve shall be available to stimulate demonstration projects in the territory of the EU that are aiming at (i) environmentally safe CCS and/or innovative renewable energy technologies.

Market for emission allowances

The Commission will monitor the carbon market and report to the Council and Parliament if it has evidence that the market is not functioning properly. In case of excessive price fluctuations, remedial measures may be adopted.

By 31 December 2010, the Commission will examine if the market for emission allowances is sufficiently protected from insider dealing and market manipulation (in accordance with Directive 2003/6/EC on insider dealing and market manipulation) and suggest measures if appropriate.

EU-based emission reduction projects

The New EU ETS provides for the possibility that tradable emission allowances are obtained from emission reduction projects in the EU, provided that this does not result in “double counting” nor impede other policy measures to reduce emissions not covered by the EU ETS.

Linking to other emissions trading systems

Third countries neighbouring the EU are encouraged to join the EU ETS. The New EU ETS Directive also provides that agreements may be made for the recognition of allowances between the EU ETS and other mandatory GHG emissions trading systems compatible with that of the EU.

Use of CERs and ERUs

In Phase III of the EU ETS, an operator may only use CERs and ERUs for compliance to the extent that
(i) the level of CER/ERU use allowed by its Member State for Phase II has not been used up, or (ii) an additional entitlement to use these credits is granted under the New EU ETS Directive. Furthermore, the credits must stem from project types which were eligible for use in the EU ETS during Phase II. If these conditions are met, Phase III allowances (valid from 2013 onwards) can be obtained in exchange for:

- CERs and ERUs issued in respect of emission reductions achieved during Phase II (these must be exchanged prior to 31 March 2015);
- CERs and ERUs issued in respect of emission reductions achieved from 2013 onwards from projects registered before 2013; and
- CERs from new projects started from 2013 onwards in Least Developed Countries.

In the event that the negotiations on a post-Kyoto international agreement on climate change are not concluded by 31 December 2009, credits from new projects or other emissions reduction activities may be used in the EU ETS in accordance with agreements concluded with third countries, but - again- only to the extent that the relevant Phase II levels of CER/ERU use have not been used up.

The entitlement to use CERs and ERUs additional to the unused part of the Phase II levels (as referred to in (ii) above) is provided for in a complex paragraph, which aims to ensure that the overall use of credits does not exceed 50% of the EU-wide reductions of the existing sectors under the EU ETS for the period 2008-2020 and 50% of the EU-wide reductions below the 2005 levels of new sectors and aviation for the period 2013-2020. Measures will be adopted to specify the exact percentages of allowed use of CERs and ERUs by existing operators and new entrants.

As of 1 January 2013, the use of specific credits from project types may be restricted in accordance with measures which are still to be adopted. It is unclear which timing and criteria shall be applied in order to adopt such measures, which are not mentioned in the New EU ETS Directive itself. Only recitals state that the exclusion of specific credits for project types should ensure that operators only use credits from projects that provide real, verifiable, additional and permanent emissions reductions and have clear sustainable development benefits and no significant negative environmental or social impact.

The above mentioned measures on the percentages of allowed used of CERs and ERUs and on the exclusion of specific credits shall be adopted by the European Commission in accordance with a regulatory procedure called “with scrutiny” which requires, amongst others, the submission by the European Commission of the draft measures for scrutiny to the European Parliament and the Council prior to the adoption of the relevant measures.

If an international post-Kyoto agreement is reached (leading to mandatory reductions exceeding 20% by 2020), access to credits from projects in third countries should be increased simultaneously with the increase in the level of emissions reductions to be achieved through the EU ETS. However, credits additional to those provided for in the New EU ETS Directive will then only be accepted from projects in third countries that ratify the international agreement.

Harmonisation

The New EU ETS Directive harmonises several elements of the EU ETS that are currently decided at the Member State level.

No more National Allocation Plans

As the quantity of allowances to be auctioned or allocated free of charge will be determined at the EU level, there will be no more need for National Allocation Plans.

Community registry

EU allowances issued from January 2012 onwards will be held in a consolidated Community registry. To that effect, the EU Registry Regulation was amended last year (see EC Regulation 994/2008 of 8 October 2008).

Monitoring and verification

By 31 December 2011, the Commission is to adopt a regulation for monitoring and reporting and a regulation for verification and accreditation. This will allow, among other things, EU-wide accreditation for verifiers.

Areas without change

The EU ETS will continue to be the EU’s main tool for achieving its emissions reduction commitments.

Banking

The possibility of carrying forward unsurrendered allowances from one trading period to the next (“banking”) is not affected by the New EU ETS Directive. It will therefore be possible to convert Phase II allowances into Phase III allowances (valid from 2013 onwards).

The way forward

The New EU ETS Directive will enter into force on the 20th day following its publication in the Official Journal of the European Union. Member States must implement the New EU ETS Directive in their national laws, regulations and administrative provisions by 31 December 2012 at the latest and apply the provisions from 1 January 2013.

Contact information

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