

Brussels, 17 December 2008

Questions and Answers on the revised EU Emissions Trading System

1) What is the aim of emissions trading?

The aim of the EU Emissions Trading System (EU ETS) is to help EU Member States achieve their commitments to limit or reduce greenhouse gas emissions in a cost-effective way. Allowing participating companies to buy or sell emission allowances means that emission cuts can be achieved at least cost.

The EU ETS is the cornerstone of the EU's strategy for fighting climate change. It is the first international trading system for CO₂ emissions in the world and has been in operation since 2005. As of 1 January 2008 it applies not only to the 27 EU Member States, but also to the other three members of the European Economic Area – Norway, Iceland and Liechtenstein. It currently covers over 10,000 installations in the energy and industrial sectors which are collectively responsible for close to half of the EU's emissions of CO₂ and 40% of its total greenhouse gas emissions. An amendment to the EU ETS Directive agreed in July 2008 will bring the aviation sector into the system from 2012.

2) How does emissions trading work?

The EU ETS is a 'cap and trade' system, that is to say it caps the overall level of emissions allowed but, within that limit, allows participants in the system to buy and sell allowances as they require. These allowances are the common trading 'currency' at the heart of the system. One allowance gives the holder the right to emit one tonne of CO₂ or the equivalent amount of another greenhouse gas. The cap on the total number of allowances creates scarcity in the market.

In the first and second trading period under the scheme, Member States had to draw up national allocation plans (NAPs) which determine their total level of ETS emissions and how many emission allowances each installation in their country receives. At the end of each year installations must surrender allowances equivalent to their emissions. Companies that keep their emissions below the level of their allowances can sell their excess allowances. Those facing difficulty in keeping their emissions in line with their allowances have a choice between taking measures to reduce their own emissions – such as investing in more efficient technology or using less carbon-intensive energy sources – or buying the extra allowances they need on the market, or a combination of the two. Such choices are likely to be determined by relative costs. In this way, emissions are reduced wherever it is most cost-effective to do so.

3) How long has the EU ETS been operating?

The EU ETS was launched on 1 January 2005. The first trading period ran for three years to the end of 2007 and was a 'learning by doing' phase to prepare for the crucial second trading period. The second trading period began on 1 January 2008 and runs for five years until the end of 2012. The importance of the second trading period stems from the fact that it coincides with the first commitment period of the Kyoto Protocol, during which the EU and other industrialised countries must meet their targets to limit or reduce greenhouse gas emissions. For the second trading period EU ETS emissions have been capped at around 6.5% below 2005 levels to help ensure that the EU as a whole, and Member States individually, deliver on their Kyoto commitments.

4) What are the main lessons learned from experience so far?

The EU ETS has put a price on carbon and proved that trading in greenhouse gas emissions works. The first trading period successfully established the free trading of emission allowances across the EU, put in place the necessary infrastructure and developed a dynamic carbon market. The environmental benefit of the first phase may be limited due to excessive allocation of allowances in some Member States and some sectors, due mainly to a reliance on emission projections before verified emissions data became available under the EU ETS. When the publication of verified emissions data for 2005 highlighted this "over-allocation", the market reacted as would be expected by lowering the market price of allowances. The availability of verified emissions data has allowed the Commission to ensure that the cap on national allocations under the second phase is set at a level that results in real emission reductions.

Besides underlining the need for verified data, experience so far has shown that greater harmonisation within the EU ETS is imperative to ensure that the EU achieves its emissions reductions objectives at least cost and with minimal competitive distortions. The need for more harmonisation is clearest with respect to how the cap on overall emission allowances is set.

The first two trading periods also show that widely differing national methods for allocating allowances to installations threaten fair competition in the internal market. Furthermore, greater harmonisation, clarification and refinement are needed with respect to the scope of the system, the access to credits from emission-reduction projects outside the EU, the conditions for linking the EU ETS to emissions trading systems elsewhere and the monitoring, verification and reporting requirements.

5) What are the main changes to the EU ETS and as of when will they apply?

The agreed design changes will apply as of the third trading period, i.e. January 2013. While preparatory work will be initiated immediately, the applicable rules will not change until January 2013 to ensure that regulatory stability is maintained.

The EU ETS in the third period will be a more efficient, more harmonised and fairer system.

Increased efficiency is achieved by means of a longer trading period (8 years instead of 5 years), a robust and annually declining emissions cap (21% reduction in 2020 compared to 2005) and a substantial increase in the amount of auctioning (from less than 4% in phase 2 to more than half in phase 3).

More harmonisation has been agreed in many areas, including with respect to the cap-setting (an EU-wide cap instead of the national caps in phases 1 and 2) and the rules for transitional free allocation.

The fairness of the system has been substantially increased by the move towards EU-wide free allocation rules for industrial installations and by the introduction of a redistribution mechanism that entitles new Member States to auction more allowances.

6) How does the final text compare to the initial Commission proposal?

The climate and energy targets agreed by the 2007 Spring European Council have been maintained and the overall architecture of the Commission's proposal on the EU ETS remains intact. That is to say that there will be one EU-wide cap on the number of emission allowances and this cap will decrease annually along a linear trend line, which will continue beyond the end of the third trading period (2013-2020). The main difference as compared to the proposal is that auctioning of allowances will be phased in more slowly.

7) What are the main changes compared to the Commission's proposal?

In summary, the main changes that have been made to the proposal are as follows:

- Certain Member States are allowed **an optional and temporary derogation** from the rule that no allowances are to be allocated free of charge to electricity generators as of 2013. This option to derogate is available to Member States which fulfil certain conditions related to the interconnectivity of their electricity grid, share of a single fossil fuel in electricity production, and GDP/capita in relation to the EU-27 average. In addition, the amount of free allowances that a Member State can allocate to power plants is **limited** to 70% of carbon dioxide emissions of relevant plants in phase 1 and declines in the years thereafter. Furthermore free allocation in phase 3 can only be given to power plants that are operational or under construction no later than end 2008. See reply to question 15 below.
- There will be more details in the Directive on the criteria to be used to determine the sectors or sub-sectors deemed to be exposed to a significant risk of **carbon leakage**, and an earlier date of publication of the Commission's list of such sectors (31 December 2009). Moreover, subject to review when a satisfactory international agreement is reached, installations in all exposed industries will receive 100% free allowances to the extent that they use the most efficient technology. The free allocation to industry is limited to the share of these industries' emissions in total emissions in 2005 to 2007. The total number of allowances allocated for free to installations in industry sectors will decline annually in line with the decline of the emissions cap.

- Member States may also compensate certain installations for CO₂ costs passed on in electricity prices if the CO₂ costs might otherwise expose them to the risk of carbon leakage. The Commission has undertaken to modify the Community guidelines on state aid for environmental protection in this respect. See reply to question 15 below.
- The **level of auctioning** of allowances for non-exposed industry will increase in a linear manner as proposed by the Commission, but rather than reaching 100% by 2020 it will reach 70%, with a view to reaching 100% by 2027.
- As foreseen in the Commission's proposal, 10% of the **allowances for auctioning** will be redistributed from Member States with high per capita income to those with low per capita income in order to strengthen the financial capacity of the latter to invest in climate friendly technologies. A provision has been added for another redistributive mechanism of 2% of auctioned allowances to take into account Member States which in 2005 had achieved a reduction of at least 20% in greenhouse gas emissions compared with the reference year set by the Kyoto Protocol.
- The share of auctioning revenues that Member States are recommended to use to fight and adapt to climate change mainly within the EU, but also in developing countries, is raised from 20% to 50%.
- The text provides for a top-up to the proposed permitted level of use of **JI/CDM** credits in the 20% scenario for existing operators that received the lowest budgets to import and use such credits in relation to allocations and access to credits in the period 2008-2012. New sectors, new entrants in the periods 2013-2020 and 2008-2012 will also be able to use credits. The total amount of credits that may be used will, however, not exceed 50% of the reduction between 2008 and 2020. Based on a stricter emissions reduction in the context of a satisfactory international agreement, the Commission could allow additional access to CERs and ERUs for operators in the Community scheme. See reply to question 20 below.
- The proceeds from auctioning 300 million allowances from the new entrants reserve will be used to support up to 12 carbon **capture and storage** demonstration projects and projects demonstrating innovative renewable energy technologies. A number of conditions are attached to this financing mechanism. See reply to question 30 below.
- The possibility to **opt-out** small combustion installations provided they are subject to equivalent measures has been extended to cover **all small installations** irrespective of activity, the emission threshold has been raised from 10,000 to 25,000 tonnes of CO₂ per year, and the capacity threshold that combustion installations have to fulfil in addition has been raised from 25MW to 35MW. With these increased thresholds, the share of covered emissions that would potentially be excluded from the emissions trading system becomes significant, and consequently a provision has been added to allow for a corresponding reduction of the EU-wide cap on allowances.

8) Will there still be national allocation plans (NAPs)?

No. In their NAPs for the first (2005-2007) and the second (2008-2012) trading periods, Member States determined the total quantity of allowances to be issued – the cap – and how these would be allocated to the installations concerned. This approach has generated significant differences in allocation rules, creating an incentive for each Member State to favour its own industry, and has led to great complexity.

As from the third trading period, there will be a single EU-wide cap and allowances will be allocated on the basis of harmonised rules. National allocation plans will therefore not be needed any more.

9) How will the emission cap in phase 3 be determined?

The rules for calculating the EU-wide cap are as follows:

From 2013, the total number of allowances will decrease annually in a linear manner. The starting point of this line is the average total quantity of allowances (phase 2 cap) to be issued by Member States for the 2008-12 period, adjusted to reflect the broadened scope of the system from 2013 as well as any small installations that Member States have chosen to exclude. The linear factor by which the annual amount shall decrease is 1.74% in relation to the phase 2 cap.

The starting point for determining the linear factor of 1.74% is the 20% overall reduction of greenhouse gases compared to 1990, which is equivalent to a 14% reduction compared to 2005. However, a larger reduction is required of the EU ETS because it is cheaper to reduce emissions in the ETS sectors. The division that minimises overall reduction cost amounts to:

- a 21% reduction in EU ETS sector emissions compared to 2005 by 2020;
- a reduction of around 10% compared to 2005 for the sectors that are not covered by the EU ETS.

The 21% reduction in 2020 results in an ETS cap in 2020 of a maximum of 1720 million allowances and implies an average phase 3 cap (2013 to 2020) of some 1846 million allowances and a reduction of 11% compared to the phase 2 cap.

All absolute figures indicated correspond to the coverage at the start of the second trading period and therefore don't take account of aviation, which will be added in 2012, and other sectors that will be added in phase 3.

The final figures for the annual emission caps in phase 3 will be determined and published by the Commission by 30 September 2010.

10) How will the emission cap beyond phase 3 be determined?

The linear factor of 1.74% used to determine the phase 3 cap will continue to apply beyond the end of the trading period in 2020 and will determine the cap for the fourth trading period (2021 to 2028) and beyond. It may be revised by 2025 at the latest. In fact, significant emission reductions of 60%-80% compared to 1990 will be necessary by 2050 to reach the strategic objective of limiting the global average temperature increase to not more than 2°C above pre-industrial levels.

11) An EU-wide cap on emission allowances will be determined for each individual year. Will this reduce flexibility for the installations concerned?

No, flexibility for installations will not be reduced at all. In any year, the allowances to be auctioned and distributed have to be issued by the competent authorities by 28 February. The last date for operators to surrender allowances is 30 April of the year following the year in which the emissions took place. So operators receive allowances for the current year before they have to surrender allowances to cover their emissions for the previous year. Allowances remain valid throughout the trading period and any surplus allowances can now be "banked" for use in subsequent trading periods. In this respect nothing will change.

The system will remain based on trading periods, but the third trading period will last eight years, from 2013 to 2020, as opposed to five years for the second phase from 2008 to 2012.

For the second trading period Member States generally decided to allocate equal total quantities of allowances for each year. The linear decrease each year from 2013 will correspond better to expected emissions trends over the period.

12) What are the tentative annual ETS cap figures for the period 2013 to 2020?

The tentative annual cap figures are as follows:

year	Mio t CO ₂
2013	1.974
2014	1.937
2015	1.901
2016	1.865
2017	1.829
2018	1.792
2019	1.756
2020	1.720

These figures are based on the scope of the ETS as applicable in phase 2 (2008 to 2012), and the Commission's decisions on the national allocation plans for phase 2, amounting to 2083 million tonnes. These figures will be adjusted for several reasons. Firstly, adjustment will be made to take into account the extensions of the scope in phase 2, provided that Member States substantiate and verify their emissions accruing from these extensions. Secondly, adjustment will be made with respect to further extensions of the scope of the ETS in the third trading period. Thirdly, any opt-out of small installations will lead to a corresponding reduction of the cap. Fourthly, the figures do not take account of the inclusion of aviation, nor of emissions from Norway, Iceland and Liechtenstein.

13) Will allowances still be allocated for free?

Yes. Industrial installations will receive transitional free allocation. And in those Member States that are eligible for the optional derogation, power plants may, if the Member State so decides, also receive free allowances. It is estimated that at least half of the available allowances as of 2013 will be auctioned.

While the great majority of allowances has been allocated free of charge to installations in the first and second trading periods, the Commission proposed that auctioning of allowances should become the basic principle for allocation. This is because auctioning best ensures the efficiency, transparency and simplicity of the system and creates the greatest incentive for investments in a low-carbon economy. It best complies with the “polluter pays principle” and avoids giving windfall profits to certain sectors that have passed on the notional cost of allowances to their customers despite receiving them for free.

14) How will allowances be handed out for free?

By 31 December 2010, the Commission will adopt EU-wide rules, which will be developed under a committee procedure (“Comitology”). These rules will fully harmonise allocations and thus all firms across the EU with the same or similar activities will be subject to the same rules. The rules will ensure as far as possible that the allocation promotes carbon-efficient technologies. The adopted rules provide that to the extent feasible, allocations are to be based on so-called benchmarks, e.g. a number of allowances per quantity of historical output. Such rules reward operators that have taken early action to reduce greenhouse gases, better reflect the polluter pays principle and give stronger incentives to reduce emissions, as allocations would no longer depend on historical emissions. All allocations are to be determined before the start of the third trading period and no ex-post adjustments will be allowed.

15) Which installations will receive free allocations and which will not? How will negative impacts on competitiveness be avoided?

Taking into account their ability to pass on the increased cost of emission allowances, full auctioning is the rule from 2013 onwards for electricity generators. However, Member States who fulfil certain conditions relating to their interconnectivity or their share of fossil fuels in electricity production and GDP per capita in relation to the EU-27 average, have the *option* to temporarily deviate from this rule with respect to existing power plants. The auctioning rate in 2013 is to be *at least* 30% in relation to emissions in the first period and has to increase progressively to 100% no later than 2020. If the option is applied, the Member State has to undertake to invest in improving and upgrading of the infrastructure, in clean technologies and in diversification of their energy mix and sources of supply for an amount to the extent possible equal to the market value of the free allocation.

In other sectors, allocations for free will be phased out progressively from 2013, with Member States agreeing to start at 20% auctioning in 2013, increasing to 70% auctioning in 2020 with a view to reaching 100% in 2027. However, an exception will be made for installations in sectors that are found to be exposed to a significant risk of 'carbon leakage'. This risk could occur if the EU ETS increased production costs so much that companies decided to relocate production to areas outside the EU that are not subject to comparable emission constraints. The Commission will determine the sectors concerned by 31 December 2009. To do this, the Commission will assess *inter alia* whether the direct and indirect additional production costs induced by the implementation of the ETS Directive as a proportion of gross value added exceed 5% *and* whether the total value of its exports and imports divided by the total value of its turnover and imports exceeds 10%. If the result for *either* of these criteria exceeds 30%, the sector would also be considered to be exposed to a significant risk of carbon leakage. Installations in these sectors would receive 100% of their share in the annually declining total quantity of allowances for free. The share of these industries' emissions is determined in relation to total ETS emissions in 2005 to 2007.

CO₂ costs passed on in electricity prices could also expose certain installations to the risk of carbon leakage. In order to avoid such risk, Member States may grant a compensation with respect to such costs. In the absence of an international agreement on climate change, the Commission has undertaken to modify the Community guidelines on state aid for environmental protection in this respect.

Under an international agreement which ensures that competitors in other parts of the world bear a comparable cost, the risk of carbon leakage may well be negligible. Therefore, by 30 June 2010, the Commission will carry out an in-depth assessment of the situation of energy-intensive industry and the risk of carbon leakage, in the light of the outcome of the international negotiations and also taking into account any binding sectoral agreements that may have been concluded. The report will be accompanied by any proposals considered appropriate. These could potentially include maintaining or adjusting the proportion of allowances received free of charge to industrial installations that are particularly exposed to global competition or including importers of the products concerned in the ETS.

16) Who will organise the auctions and how will they be carried out?

Member States will be responsible for ensuring that the allowances given to them are auctioned. Each Member State has to decide whether it wants to develop its own auctioning infrastructure and platform or whether it wants to cooperate with other Member States to develop regional or EU-wide solutions. The distribution of the auctioning rights to Member States is largely based on emissions in phase 1 of the EU ETS, but a part of the rights will be redistributed from richer Member States to poorer ones to take account of the lower GDP per head and higher prospects for growth and emissions among the latter. It is still the case that 10% of the rights to auction allowances will be redistributed from Member States with high per capita income to those with low per capita income in order to strengthen the financial capacity of the latter to invest in climate friendly technologies. However, a provision has been added for another redistributive mechanism of 2% to take into account Member States which in 2005 had achieved a reduction of at least 20% in greenhouse gas emissions compared with the reference year set by the Kyoto Protocol. Nine Member States benefit from this provision.

Any auctioning must respect the rules of the internal market and must therefore be open to any potential buyer under non-discriminatory conditions. By 30 June 2010, the Commission will adopt a Regulation (through the comitology procedure) that will provide the appropriate rules and conditions for ensuring efficient, coordinated auctions without disturbing the allowance market.

17) How many allowances will each Member State auction and how is this amount determined?

All allowances which are not allocated free of charge will be auctioned. A total of 88% of allowances to be auctioned by each Member State is distributed on the basis of the Member State's share of historic emissions under the EU ETS. For purposes of solidarity and growth, 12% of the total quantity is distributed in a way that takes into account GDP per capita and the achievements under the Kyoto-Protocol.

18) Which sectors and gases are covered as of 2013?

The ETS covers installations performing specified activities. Since the start it has covered, above certain capacity thresholds, power stations and other combustion plants, oil refineries, coke ovens, iron and steel plants and factories making cement, glass, lime, bricks, ceramics, pulp, paper and board. As for greenhouse gases, it currently only covers carbon dioxide emissions, with the exception of the Netherlands, which has opted in emissions from nitrous oxide.

As from 2013, the scope of the ETS will be extended to also include other sectors and greenhouse gases. CO₂ emissions from petrochemicals, ammonia and aluminium will be included, as will N₂O emissions from the production of nitric, adipic and glycolic acid production and perfluorocarbons from the aluminium sector. The capture, transport and geological storage of all greenhouse gas emissions will also be covered. These sectors will receive allowances free of charge according to EU-wide rules, in the same way as other industrial sectors already covered.

As of 2012, aviation will also be included in the EU ETS.

19) Will small installations be excluded from the scope?

A large number of installations emitting relatively low amounts of CO₂ are currently covered by the ETS and concerns have been raised over the cost-effectiveness of their inclusion. As from 2013, Member States will be allowed to remove these installations from the ETS under certain conditions. The installations concerned are those whose reported emissions were lower than 25 000 tonnes of CO₂ equivalent in each of the 3 years preceding the year of application. For combustion installations, an additional capacity threshold of 35MW applies. In addition Member States are given the possibility to exclude installations operated by hospitals. The installations may be excluded from the ETS only if they will be covered by measures that will achieve an equivalent contribution to emission reductions.

20) How many emission credits from third countries will be allowed?

For the second trading period, Member States allowed their operators to use significant quantities of credits generated by emission-saving projects undertaken in third countries to cover part of their emissions in the same way as they use ETS allowances. The revised Directive extends the rights to use these credits for the third trading period and allows a limited additional quantity to be used in such a way that the overall use of credits is limited to 50% of the EU-wide reductions over the period 2008-2020. For existing installations, and excluding new sectors within the scope, this will represent a total level of access of approximately 1.6 billion credits over the period 2008-2020. In practice, this means that existing operators will be able to use credits up to a minimum of 11% of their allocation during the period 2008-2012, while a top-up is foreseen for operators with the lowest sum of free allocation and allowed use of credits in the 2008-2012 period. New sectors and new entrants in the third trading period will have a guaranteed minimum access of 4.5% of their verified emissions during the period 2013-2020. For the aviation sector, the minimum access will be 1.5%. The precise percentages will be determined through comitology.

These projects must be officially recognised under the Kyoto Protocol's Joint Implementation (JI) mechanism (covering projects carried out in countries with an emissions reduction target under the Protocol) or Clean Development Mechanism (CDM) (for projects undertaken in developing countries). Credits from JI projects are known as Emission Reduction Units (ERUs) while those from CDM projects are called Certified Emission Reductions (CERs).

On the quality side only credits from project types eligible for use in the EU trading scheme during the period 2008-2012 will be accepted in the period 2013-2020. Furthermore, from 1 January 2013 measures may be applied to restrict the use of specific credits from project types. Such a quality control mechanism is needed to assure the environmental and economic integrity of future project types.

To create greater flexibility, and in the absence of an international agreement being concluded by 31 December 2009, credits could be used in accordance with agreements concluded with third countries. The use of these credits should however not increase the overall number beyond 50% of the required reductions. Such agreements would not be required for new projects that started from 2013 onwards in Least Developed Countries.

Based on a stricter emissions reduction in the context of a satisfactory international agreement, additional access to credits could be allowed, as well as the use of additional types of project credits or other mechanisms created under the international agreement. However, once an international agreement has been reached, from January 2013 onwards only credits from projects in third countries that have ratified the agreement or from additional types of project approved by the Commission will be eligible for use in the Community scheme.

21) Will it be possible to use credits from carbon 'sinks' like forests?

No. Before making its proposal, the Commission analysed the possibility of allowing credits from certain types of land use, land-use change and forestry ('LULUCF') projects which absorb carbon from the atmosphere. It concluded that doing so could undermine the environmental integrity of the EU ETS, for the following reasons:

- LULUCF projects cannot physically deliver permanent emissions reductions. Insufficient solutions have been developed to deal with the uncertainties, non-permanence of carbon storage and potential emissions 'leakage' problems arising from such projects. The temporary and reversible nature of such activities would pose considerable risks in a company-based trading system and impose great liability risks on Member States.
- The inclusion of LULUCF projects in the ETS would require a quality of monitoring and reporting comparable to the monitoring and reporting of emissions from installations currently covered by the system. This is not available at present and is likely to incur costs which would substantially reduce the attractiveness of including such projects.
- The simplicity, transparency and predictability of the ETS would be considerably reduced. Moreover, the sheer quantity of potential credits entering the system could undermine the functioning of the carbon market unless their role were limited, in which case their potential benefits would become marginal.

The Commission, the Council and the European Parliament believe that global deforestation can be better addressed through other instruments. For example, using part of the proceeds from auctioning allowances in the EU ETS could generate additional means to invest in LULUCF activities both inside and outside the EU, and may provide a model for future expansion. In this respect the Commission has proposed to set up the Global Forest Carbon Mechanism that would be a performance-based system for financing reductions in deforestation levels in developing countries¹.

22) Besides those already mentioned, are there other credits that could be used in the revised ETS?

Yes. Projects in EU Member States which reduce greenhouse gas emissions not covered by the ETS could issue credits. These Community projects would need to be managed according to common EU provisions set up by the Commission in order to be tradable throughout the system. Such provisions would be adopted only for projects that cannot be realised through inclusion in the ETS. The provisions will seek to ensure that credits from Community projects do not result in double-counting of emission reductions nor impede other policy measures to reduce emissions not covered by the ETS, and that they are based on simple, easily administered rules.

23) Are there measures in place to ensure that the price of allowances won't fall sharply during the third trading period?

A stable and predictable regulatory framework is vital for market stability. The revised Directive makes the regulatory framework as predictable as possible in order to boost stability and rule out policy-induced volatility. Important elements in this respect are the determination of the cap on emissions in the Directive well in advance of the start of the trading period, a linear reduction factor for the cap on emissions which continues to apply also beyond 2020 and the extension of the trading period from 5 to 8 years. The sharp fall in the allowance price during the first trading period was due to over-allocation of allowances which could not be "banked" for use in the second trading period. For the second and subsequent trading periods, Member States are obliged to allow the banking of allowances from one period to the next and therefore the end of one trading period is not expected to have any impact on the price.

A new provision will apply as of 2013 in case of excessive price fluctuations in the allowance market. If, for more than six consecutive months, the allowance price is more than three times the average price of allowances during the two preceding years on the European market, the Commission will convene a meeting with Member States. If it is found that the price evolution does not correspond to market fundamentals, the Commission may either allow Member States to bring forward the auctioning of a part of the quantity to be auctioned, or allow them to auction up to 25% of the remaining allowances in the new entrant reserve.

¹ Communication from the Commission "Addressing the challenges of deforestation and forest degradation to tackle climate change and biodiversity loss", COM(2008) 645 final

The price of allowances is determined by supply and demand and reflects fundamental factors like economic growth, fuel prices, rainfall and wind (availability of renewable energy) and temperature (demand for heating and cooling) etc. A degree of uncertainty is inevitable for such factors. The markets, however, allow participants to hedge the risks that may result from changes in allowances prices.

24) Are there any provisions for linking the EU ETS to other emissions trading systems?

Yes. One of the key means to reduce emissions more cost-effectively is to enhance and further develop the global carbon market. The Commission sees the EU ETS as an important building block for the development of a global network of emission trading systems. Linking other national or regional cap-and-trade emissions trading systems to the EU ETS can create a bigger market, potentially lowering the aggregate cost of reducing greenhouse gas emissions. The increased liquidity and reduced price volatility that this would entail would improve the functioning of markets for emission allowances. This may lead to a global network of trading systems in which participants, including legal entities, can buy emission allowances to fulfil their respective reduction commitments.

The EU is keen to work with the new US Administration to build a transatlantic and indeed global carbon market to act as the motor of a concerted international push to combat climate change.

While the original Directive allows for linking the EU ETS with other industrialised countries that have ratified the Kyoto Protocol, the new rules allow for linking with any country or administrative entity (such as a state or group of states under a federal system) which has established a compatible mandatory cap-and-trade system whose design elements would not undermine the environmental integrity of the EU ETS. Where such systems cap absolute emissions, there would be mutual recognition of allowances issued by them and the EU ETS.

25) What is a Community registry and how does it work?

Registries are standardised electronic databases ensuring the accurate accounting of the issuance, holding, transfer and cancellation of emission allowances. As a signatory to the Kyoto Protocol in its own right, the Community is also obliged to maintain a registry. This is the Community Registry, which is distinct from the registries of Member States. Allowances issued from 1 January 2013 onwards will be held in the Community registry instead of in national registries.

26) Will there be any changes to monitoring, reporting and verification requirements?

The Commission will adopt a new Regulation (through the comitology procedure) by 31 December 2011 governing the monitoring and reporting of emissions from the activities listed in Annex I of the Directive. A separate Regulation on the verification of emission reports and the accreditation of verifiers should specify conditions for accreditation, mutual recognition and cancellation of accreditation for verifiers, and for supervision and peer review as appropriate.

27) What provision will be made for new entrants into the market?

Five percent of the total quantity of allowances will be put into a reserve for new installations or airlines that enter the system after 2013 ("new entrants"). The allocations from this reserve should mirror the allocations to corresponding existing installations.

A part of the new entrant reserve, amounting to 300 million allowances, will be made available to support the investments in up to 12 demonstration projects using the carbon capture and storage technology and demonstration projects using innovative renewable energy technologies. There should be a fair geographical distribution of the projects.

In principle, any allowances remaining in the reserve shall be distributed to Member States for auctioning. The distribution key shall take into account the level to which installations in Member States have benefited from this reserve.

28) What has been agreed with respect to the financing of the 12 carbon capture and storage demonstration projects requested by a previous European Council?

The European Parliament's Environment Committee tabled an amendment to the EU ETS Directive requiring allowances in the new entrant reserve to be set aside in order to co-finance up to 12 demonstration projects as requested by the European Council in spring 2007. This amendment has later been extended to include also innovative renewable energy technologies that are not commercially viable yet. Projects shall be selected on the basis of objective and transparent criteria that include requirements for knowledge sharing. Support shall be given from the proceeds of these allowances via Member States and shall be complementary to substantial co-financing by the operator of the installation. No project shall receive support via this mechanism that exceeds 15% of the total number of allowances (i.e. 45 million allowances) available for this purpose. The Member State may choose to co-finance the project as well, but will in any case transfer the market value of the attributed allowances to the operator, who will not receive any allowances.

A total of 300 million allowances will therefore be set aside until 2015 for this purpose.

29) What is the role of an international agreement and its potential impact on EU ETS?

When an international agreement is reached, the Commission shall submit a report to the European Parliament and the Council assessing the nature of the measures agreed upon in the international agreement and their implications, in particular with respect to the risk of carbon leakage. On the basis of this report, the Commission shall then adopt a legislative proposal amending the present Directive as appropriate.

For the effects on the use of credits from Joint Implementation and Clean Development Mechanism projects, please see the reply to question 20.

30) What are the next steps?

Member States have to bring into force the legal instruments necessary to comply with certain provisions of the revised Directive by 31 December 2009. This concerns the collection of duly substantiated and verified emissions data from installations that will only be covered by the EU ETS as from 2013, and the national lists of installations and the allocation to each one. For the remaining provisions, the national laws, regulations and administrative provisions only have to be ready by 31 December 2012.

The Commission has already started the work on implementation. For example, the collection and analysis of data for use in relation to carbon leakage is ongoing (list of sectors due end 2009). Work is also ongoing to prepare the Regulation on timing, administration and other aspects of auctioning (due by June 2010), the harmonised allocation rules (due end 2010) and the two Regulations on monitoring and reporting of emissions and verification of emissions and accreditation of verifiers (due end 2011).