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

1. MANDATE AND COMPOSITION

The mandate of the Group was to examine how flexible mechanisms might be further developed within the EU in the context of climate change policy. The Working Group has concentrated on the design principles of an EC-wide emissions trading scheme and the necessary regulatory framework. This includes examination of the methodology for the fixing of objectives for companies, examination of the inter-linkages between different schemes as well as with environmental negotiated agreements and other policies and measures. A Sub-group to Working Group 1 was created at the beginning of 2001 to examine Joint Implementation and the Clean Development Mechanism. This Subgroup has met for a total of three days, with a separate report being prepared on the results.

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

2. METHOD OF WORK

Working Group 1 met 10 times in all, each time for a complete day. The meetings provided a fruitful forum for discussion of some of the more technical issues related to flexible mechanisms.

The Group has enjoyed a high degree of continuity of participants and excellent levels of attendance. Furthermore, the expertise of the members has contributed to an extremely high quality of debate on what are complex technical issues that will confront any policy initiatives in this area. The Chairman is grateful to the members for their high degree of commitment to this exercise.

Working Group 1 has been rather different from other Working Groups. Rather than trying to identify and quantify measures that could be taken, the Group has concentrated on issues and choices that will have to be made in order to use such flexible mechanisms within the Community. The discussions that have taken place within the Group, and the Group's Recommendations (see below) will be of assistance to the Commission. The Commission has also been able to benefit from the experience of members of the Group

who are already involved in the development of flexible instruments. As a result of the exercise, stakeholders are better placed to understand the concerns of others in approaching these instruments.

3. SUBJECTS COVERED

Several presentations have been made to the Group. These have included presentations by Mr Brian McLEAN from the US Environmental Protection Agency & Mr Ned HELME of the Center for Clean Air Policy, Washington DC. Commission officials Mr Peter ZAPFEL and Mr Matti VAINIO (DG Environment) have also made presentations of economic analysis. Each of these presentations was for information only. However, the stimulus that they provided for the discussion amongst participants was appreciated.

To facilitate the discussions within the Group, the Commission's services prepared a total of 8 Background Documents on the following subjects:

- (1) Objective setting in the context of emissions trading and negotiated agreements;
- (2) Allocation methodologies and recognition of early action;
- (3) Fair competition and internal market issues;
- (4) International Competitiveness and flexible mechanisms;
- (5) The project mechanisms of the Kyoto Protocol and the Community role;
- (6) Elements to be made compatible for the linking of national schemes and the linking of national schemes with an EU scheme;
- (7) Monitoring, reporting, verification and compliance;
- (8) Defining the coverage: trading population and gases.

These documents have been prepared under the Chairman's responsibility alone. The views expressed in these documents have been debated by the Group as a whole, and changes have been subsequently made to try to capture the spirit of the discussions.

The Chairman's Background Documents are attached to this Final Report for information, along with the Records of the 10 meetings that have taken place. All these documents can also be found on the Commission's website at: <http://www.europa.eu.int/comm/environment/climat/eccp.htm> .

On some issues diverging views among the different stakeholders persist. Such differences of opinion include, in particular, whether participation in emissions trading should be mandatory or voluntary for certain "core" sectors. Equally, differences of opinion persisted on whether it is better to make allocations and measure emissions on a "direct" or "indirect" basis (particularly relevant for the emissions from electricity generation). However, in this context, all members agreed upon the need to avoid double-counting or the under-reporting of emissions, and that Combined Heat and Power capacity should not be discouraged. Notwithstanding that the Group has concentrated on emissions trading at entity level, it remains the view of a small number of members that EC-wide emissions trading should start between Member States, with the involvement of

entities engaged in greenhouse gas emission reductions. Some members believe that relative targets should only have a transitional role. It is also the opinion of some members that if the international rules on JI and CDM are not judged to be adequate from an environmental point of view, then additional rules at Community level on the eligibility of certain types of project, for example, would be warranted. Further consideration of these unresolved issues would be warranted.

Members have been encouraged to discuss all the documentation that has been prepared for the Working Group within their own constituencies.

The ordering of the conclusions and recommendations below is not indicative of their priority.

4. CONCLUSIONS

1. An EU emissions trading system must be environmentally effective and economically efficient, simple and transparent.
2. Policies and measures to tackle climate change, including emissions trading, should endeavour to share effort equitably between all sectors of society and emitters. Preferential treatment of one sector will necessarily have a negative impact on all the others.
3. Emission trading creates on-going motivation for businesses to seek cost-effective reductions and strive for an optimal resource allocation.
4. Initial allocation is above all a prerequisite for getting trading started, and there are a number of ways of doing it. A mixture of allocation methods may be the most practical way forward. Furthermore, a progressive evolution towards auctioning is expected over the longer-term. The choice of baseline period for grandfathering allocations will have distributional effects.
5. It is not that one Member State might allocate allowances for free and another sell them through an auction that necessarily gives rise to distortions within the internal market. The two methods of allocation might be equally demanding in terms of environmental outcome.
6. Well designed emissions trading should level competition within the EU in a way that other instruments may not be able to do, because each and every company in the trading scheme faces the same carbon market price.
7. Emissions trading is likely to reduce the overall costs of compliance with the Kyoto Protocol commitments, both to Member States and to European businesses, compared to many alternative measures.
8. The rules and modalities of trading under the Kyoto Protocol will not be sufficiently complete to impose certain design choices made within individual schemes, such as whether schemes should be “upstream” (targeted at importers and producers of fossil fuels) or “downstream” (targeted at power and heat generators and energy consumers). Similarly, the choice between schemes calculating emissions on a “direct” or “indirect” basis would not be determined by the Kyoto rules, even if the Kyoto Protocol itself uses a “direct” emissions basis for Parties.

9. Monitoring, reporting, verification and compliance underpin emissions trading systems as the guarantors of environmental integrity and the economic value of permits. Without certainty in terms of what is being exchanged, what obligations there are, and what sanctions will be imposed in the case of non-respect of these obligations, no emissions trading system – individual or collective – will work.

5. RECOMMENDATIONS

5.1. GENERAL

1. Working Group 1 recommends that emissions trading start as soon as practicable. Implementation of emissions trading within the EC should not wait for the progress made in defining the Kyoto mechanisms, and should be developed in the context of, and with a view to influencing the design of, an international scheme from 2008. A pre-Kyoto EC system should be viewed as a “learning-by-doing” process.
2. An EC emissions trading system should seek to build upon the experience of existing emissions trading markets, while offering a European format to Member States that have not established their own schemes.
3. The Working Group recommends a Community framework on emissions trading such that a “level playing field” will be easier to ensure, as will the minimisation of economic costs.
4. Emissions trading should form part of a comprehensive and coherent package of policies and measures implemented at Member State and Community level. The interactions of the Kyoto mechanisms with the existing pool of instruments currently applied must be analysed carefully and negative impacts avoided.
5. In any future EC emissions trading scheme early actions should not be penalised.
6. The further development of emissions trading should involve business, environmental NGOs and other groups, in order to ensure maximum support for the schemes developed.
7. Emissions trading in the European Union should be designed with a view to avoid undue negative impact on competitiveness, in particular for those engaged in global competition.

5.2. TYPE & STRINGENCY OF TARGETS

8. Absolute targets must be at the core of any EC-wide emissions trading scheme. But with appropriate safeguards built in, there can also be a limited role for relative targets.
9. If relative targets in the form of performance standards are used, they must ensure that – when allowing for growth in output – Member States will still be able to deliver their overall absolute emissions reductions. The same caveat applies to all policies and measures that do not guarantee absolute emissions reductions.

5.3. ALLOCATION

10. Allocation methodologies and their practical implementation should not create systematic competitive distortions.
11. Member States should be allowed to choose their own initial method of allocation, subject to obtaining any appropriate state aid approvals. The quantitative commitment required of any source engaged in emissions trading does not have to be the same as the Burden Sharing Agreement target set for the Member State in which the source is situated.
12. Allocation methodologies should be environmentally effective, which means that they should encourage early action and not reward past inaction.

5.4. COVERAGE (GASES & SECTORS)

13. It should be the objective to cover all greenhouse gases covered by the Kyoto Protocol. The Working group recommends that CO₂ is the “core” gas in the trading scheme, but that other greenhouse gases can be included on condition that monitoring capability is sufficiently robust.
14. A trading system should be designed with a view to extending it to as many sectors, entities and greenhouse gases as possible, while remaining environmentally effective, economically efficient, simple and transparent. In the initial phase of learning, the trading system should be designed with a limited but substantial number of entities, including in particular the power and heat sector, with a twofold objective: have a sufficiently simple system and obtain a sufficiently liquid market. A secondary emissions trading market could further increase efficiency and liquidity.

5.5. INTERNAL MARKET & COMPETITION ISSUES

15. Generally, in order for allowances allocated free of charge not to be defined as incompatible state aid, the allowances given to an individual entity or source should be no more than the amount of allowances that the entity or source is likely to need to cover its projected emissions in the absence of mitigation effort.
16. The application of state aid and competition rules to the initial allocation of allowances must recognise that in practice no allocation approach will be perfect, and that there will be some distributional impacts. However, trading allows for least cost compliance options to be used by all participants, and distortions are likely to be temporary.
17. It should be recognised that the use of the project mechanisms should not contravene the Community state aid and public procurement rules.

5.6. RULES OF OPERATION OF EMISSIONS TRADING WITHIN THE EC

18. In respect of the denomination of what is to be exchanged (“currency of exchange”), the creation of a single currency is recommended by the Working Group. This should be metric tonnes of CO₂-equivalent, using IPCC conversion factors between different greenhouse gases.

19. Registries must be compatible with one another. The minimum information required to be kept should be harmonised. Retired permits must, of course, be definitively taken out of the registries of the combined trading systems. Guidelines should be established that ensure full transparency, accuracy and a high degree of reliability.
20. While banking permits should be permissible within an EC trading scheme, borrowing from future commitment periods should not be allowed for any participant.

5.7. LINKS WITH PROJECT MECHANISMS

21. To complement abatement action at home, use of Joint Implementation and the Clean Development Mechanism by companies should be encouraged. This can be done by recognising JI and CDM credits towards fulfilment of domestic obligations.
22. Member States and the Community should work together to provide clear and consistent guidance on project eligibility, additionality and baseline criteria under the CDM and JI.
23. The European Community may fund both JI and CDM projects. The suitability of doing this should be decided with the Member States.
24. Consideration should be given to the establishment of domestic greenhouse gas reduction projects to generate credits that could be used towards the fulfilment of domestic obligations, including those arising under any possible Community emissions trading system. Such project mechanisms can bring emissions reductions to new areas, provided they are carefully defined to ensure that genuine emissions reductions are delivered. However, care must be taken not to delay the commencement of emissions trading within the Community.

5.8. MONITORING, REPORTING, VERIFICATION & COMPLIANCE

25. High standards of monitoring, verification, reporting and compliance are crucial for guaranteeing the environmental and financial credibility of emissions trading and should be comparable both throughout an EC-wide scheme and between linked national schemes.
26. The Working Group recommends co-ordination to guarantee a minimum level of sanctions in an EC-scheme in order to achieve the environmental outcome.
27. The Working Group underlines the importance of speedy and automatic sanctions in the case of breaches in compliance – given the speed at which markets work. It is of central importance for environmental integrity that financial penalties are substantially higher than the cost of allowances or credits.
28. Calculation probably offers the most feasible and comparable means of monitoring CO₂ emissions in most cases. The Working Group recommends that existing protocols for measurement, calculation and reporting should be used as far as possible.

This Final Report was agreed by members of Working Group 1 at its meeting of 2 May 2001.

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Principal Administrator
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