

EXPLANATORY MEMORANDUM TO
THE GREENHOUSE GAS EMISSIONS TRADING SCHEME
(AMENDMENT) AND NATIONAL EMISSIONS INVENTORY
REGULATIONS 2005

2005 No. 2903

1. This explanatory memorandum has been prepared by the Department for Environment, Food and Rural Affairs and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 This instrument amends the Greenhouse Gas Emission Trading Scheme Regulations 2005 (S.I. 2005/925) (the “ETS Regulations”) to enable operators subject to the EU Emissions Trading Scheme (the “EU ETS”) to use credits generated by the Kyoto Project mechanisms for compliance with the Scheme.

2.2 This instrument sets out the process and requirements for obtaining UK approval and authorisation for participation in the Kyoto project mechanisms (the Clean Development Mechanism and Joint Implementation).

2.3 This instrument also allows the Secretary of State to request information from operators not currently subject to the EU ETS for the purpose of expanding or seeking to expand the scope of the Scheme, and gives the Environment Agency and other regulators the power to collect all information required for the development of a National Allocation Plan.

2.4 This instrument also allows the Secretary of State to request information from regulators and other persons for the purposes of compiling the national emissions inventory, part of the UK’s obligations under the Kyoto Protocol as elaborated in the Marrakesh Accords.

3. Matters of special interest to the Joint Committee on Statutory Instruments

None.

4. Legislative Background

4.1 In October 2001 the European Commission published a proposal for the establishment of a European-wide greenhouse gas emissions trading scheme. Following negotiations between the Council and the European Parliament, the EU Emissions Trading Directive (ETD) Directive was adopted on 2 July 2003. The Directive was transposed in the UK by the Greenhouse Gas Emissions Trading Scheme Regulations 2003 which entered into force on 31 December 2003. The regulations were amended and consolidated by the Greenhouse Gas Emissions Trading Scheme Regulations 2005 which came into force on 21 April 2005.

4.2 The Directive requires the UK Government to limit the total carbon dioxide emissions from UK installations covered by the Scheme and to allocate allowances (known as European Union Allowances or EUAs) equal to this cap to the operators of individual installations. The number of EUAs that each member state intends to allocate to each installation is set out in their National Allocation Plan (NAP). By 30 April each year operators of installations will have to surrender EUAs equal to their emissions in the previous calendar year, but they will be able to trade EUAs with each other across the EU to meet this obligation. This allows operators to use the least-cost method of reducing emissions: those that find it cheaper to cut emissions will do so and sell their surplus allowances on the market, while others may find it cheaper to buy allowances in to cover emissions over and above their cap. The net effect across the EU is a reduction in CO₂ emissions.

4.3 The EU ETS commenced on 1 January 2005. The first phase runs from 2005-2007 and the second phase will run from 2008-2012 to coincide with the first Kyoto Commitment Period. The first phase covers installations that carry out activities listed in Annex I of the EU ETD and will cover emissions of carbon dioxide only. However there is scope for the scheme to be expanded in the future to cover other activities and gases, either through an amendment to the Directive or a unilateral extension of the scheme by an individual member state. The Government recently consulted on proposals for development of the Phase II NAP, and a draft Phase II NAP is to be produced for consultation around the turn of the year.

4.4 These Regulations are made under section 2(2) of the European Communities Act 1972, and in order to implement the UK's obligations under the Linking Directive (Directive 2004/101/EC), which amends Council Directive 2003/87/EC (the "Emissions Trading Directive"). These regulations also make provision for the Secretary of State to be able to approve and authorise participation in project activities under the Kyoto Mechanisms.

4.5 These Regulations also include provisions to enable data to be collected for the purpose of preparing a national emissions inventory. As a Party to the UN Framework Convention on Climate Change (UNFCCC), the UK is required to develop and update national inventories of anthropogenic emissions by sources and removals by sinks of all greenhouse gases not controlled by the Montreal Protocol. Article 4(4) of the EC Monitoring Mechanism Decision 280/2004/EC¹ requires Member States, by 31 December 2005 at the latest, to establish national inventory systems under the Kyoto Protocol for the estimation of anthropogenic emissions of greenhouse gases by sources and removals of carbon dioxide by sinks. It was therefore considered appropriate to transpose new legal powers relating to the national inventory at the same time as the Linking Directive.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

¹ Commission Decision No 280/2004/EC of the European Parliament and of the Council of 11 February 2004 concerning a mechanism for monitoring Community greenhouse gas emissions and for implementing the Kyoto Protocol.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy Background

7.1 The Linking Directive was adopted on 13 November 2004. Its provisions can be divided into two main categories:

- Provisions of the Directive providing for the possibility of allowing operators to hold and also to use credits from the project-based mechanisms (Certified Emission Reduction units – CERs – from Clean Development Mechanism (CDM) projects, and Emission Reduction Units – ERUs – from Joint Implementation (JI) projects) to comply with their obligations under the EU ETS; and
- Provisions of the Directive specifying additional criteria to be applied when approving and authorising participation in the project mechanisms under the Kyoto Protocol.

7.2 In addition to transposing the requirements of the Linking Directive, the regulations also include provisions in relation to the development of a national inventory.

(a) Provision relating to use of credits from CERs and ERUs

7.3 The Regulations permit the unlimited use of CERs from CDM projects by operators during Phase I of the trading scheme (2005-7). In Phase II (2008-2012) and subsequent scheme phases, CERs and ERUs from JI projects can both be used for compliance purposes, although a limit on their use is mandatory under the EU Directive. The draft Phase II NAP will set the limit on the use of project credits in Phase II. **The current Regulations provide for the use of project credits in Phase II and subsequent phases of the EU ETS to be subject to a limit set out in the relevant approved NAP.** In accordance with the EU Directive, CERs and ERUs generated from nuclear facilities, land use, land use change and forestry activities are inadmissible in both phases.

(b) Provisions relating to holding of Kyoto units

7.4 The Regulations provide for holding by operators of all CERs and ERUs. However, in Phase I (2005-7) only CERs (which do not result from nuclear facilities, land use, land use change or forestry project activities) may be used for compliance. In Phase II (2008-12), CERs and ERUs which do not result from nuclear activities, land use, land use change or forestry project activities may be used for compliance, up to the limit on project credits which will be set in the Phase II NAP. CERs and ERUs which may not be used for compliance may still be held in EU ETS Registry accounts.

(c) Provisions relating to project approval and authorization to participate

7.5 Defra acts as the Designated National Authority (DNA) for the CDM and the Designated Focal Point (DFP) for JI projects, and issues letters of approval in respect of both mechanisms. These Regulations set out the requirements for project approval, including the right of the Secretary of State to seek further information in making approval decisions and to require independent verification of information provided. In broad terms the requirements for receiving a letter of approval for CDM and JI projects are submission of a Project Design Document describing the project, a declaration of compliance with the relevant rules and procedures, and a copy of the host country's letter of approval. The Regulations provide that the Secretary of State will make approval decisions within a period of two months and that applicants have the right to appeal. The Secretary of State will make decisions in accordance with the international rules and with the additional EU requirements in the Linking Directive.

7.6 The participation of project participants in CDM project activities is subject to the guidance of the CDM Executive Board. The participation of project participants in JI project activities is primarily subject to supervision of the JI Supervisory Committee (for Track 2) or the relevant national authority of the host country (for Track 1).

7.7 Paragraph 11b(5) of the Linking Directive requires Parties authorising participation in projects to ensure an entity's participation is in accordance with the relevant procedures and requirements. The UK does this by obtaining a declaration of compliance with the relevant mechanism's rules and by creation of a criminal offence for knowingly or recklessly supplying false information. In addition, the host party in their letter of approval, or the independent verifier must provide a statement to confirm that the baseline has taken into account the requirements of European Community law.

7.8 The Linking Directive lays down specific requirements as regards projects involving large dams. It states that in the case of projects with a generating capacity exceeding 20MW, Member States must take into account relevant criteria when approving such projects, including that set out in the World Commission on Dams (WCD) November 2000 Report "Dams and Development – A New Framework for Decision-Making". To fulfil this obligation, the UK requires a separate declaration for projects which relate to such dams, indicating that they comply with the necessary criteria.

(d) Provisions relating to national emissions inventory data

7.9 There is a Community obligation to include provisions relating to national emissions inventory data: Article 4(4) of the EC Monitoring Mechanism Decision 280/2004/EC requires member states to establish national inventory systems under the Kyoto Protocol by 31 December 2005. As stated in paragraph 4.5, above, it was considered appropriate to transpose new legal powers relating to the national inventory at the same time as the Linking Directive.

7.10 Parties to the Kyoto Protocol are required to develop a national system for estimating greenhouse gas emissions and removals. The new powers set out in these Regulations provide a back-up to current arrangements and ensure that the

UK is always able to collect the information required to develop a national inventory in order to meet its legally binding obligations under the UNFCCC, the Kyoto Protocol and EU law. It is intended only to exercise this power as a last resort when all other attempts to meet a request have failed.

7.11 The new statutory powers take the form of a notice issued by the Secretary of State to any person deemed to be withholding information required for the preparation of the national emissions inventory. The notice will specify the type of information that is required, its form and the date by which it should be provided. The Secretary of State can also authorise any person to enter premises for the purposes of obtaining or verifying information needed for preparing the national inventory. These powers are to be agreed with the relevant authorities in Scotland, Wales and Northern Ireland where the notice or powers of entry apply to installations in these countries. It is an offence to fail to comply with the terms of a notice or obstruct authorised persons with powers of entry, and the Regulations specify the type of penalty that could apply (fine or imprisonment).

Consultation

7.12 Government launched a 10-week public consultation on the draft Regulations on 10 June 2005. The reduction from the usual consultation period of 12 weeks was made because the timeframes set out in the Directive for implementing the EU ETS were very tight. This shortened consultation was made up for by stakeholder workshops held in London and Edinburgh which provided operators and interested parties with more detail on the Linking Directive and the scope of the consultation.

7.13 In total, 49 consultation responses were received from a wide range of stakeholder groups, including EU ETS operators, representatives from the carbon market, NGOs and public sector organisations. Opinions varied significantly between stakeholder groups and not all respondents answered every question. However, the majority of respondents agreed with the use of CERs without qualitative or quantitative limits; with the authority of the Secretary of State to approve projects; and with the establishment of new powers requiring the collection of information for the national inventory. These changes have been reflected in the amended regulations, as detailed above. Consultation details can be found on the Defra website at:

<http://www.defra.gov.uk/corporate/consult/euets-linkingdir/index.htm>

7.14 Government will publish guidance notes for operators to accompany the Regulations on the Defra website following the laying of this instrument. These will cover all aspects of the Regulations, including the use of project credits in Phase I, project approval processes and provisions relating to the national emissions inventory.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The impact on the public sector is to enable the Secretary of State to give effect to policy decisions regarding the implementation of the Linking Directive in the UK, to approve and authorise the participation in project activities, to deal with appeals, and to enable the establishment in the UK of a national inventory on greenhouse gas emissions and removals.

9. Contact

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TRANSPOSITION NOTE

The Greenhouse Gas Emissions Trading Scheme (Amendment) and National Emissions Inventory Regulations 2005

Transposition of Directive 2004/101/EC of the European Parliament and of the Council amending Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms

Article	Objective	Implementation
Article 1(1)	This article inserts new interpretation provisions into Directive 2003/87/EC which have no operative effect.	No transposition necessary
Article 1(2) – inserting Article 11a(1) into Directive 2003/87/EC	Allows Member States to permit operators to use CERs and ERUs in order to secure compliance with their obligations under the EU Emissions Trading Scheme in the second and subsequent phases of the Scheme, up to the limit provided for in the national allocation plan.	Regulation 4(b) inserts regulation 26(17) into the Greenhouse Gas Emissions Trading Scheme Regulations 2005 (“the 2005 regulations”), which enables an operator to hold CERs and ERUs in its registry accounts. Regulation 27A(1) permits an operator to use CERs and ERUs to comply with its obligations to surrender allowances under the Scheme. Regulation 27A(4) provides an exception to this by limiting the use of CERs and ERUs to the limit set out in the approved national allocation plan for that period.
Article 1(2) – inserting Article 11a(2) into Directive 2003/87/EC	Allows Member States to permit operators to use CERs in order to secure compliance with their obligations under the EU	Regulation 4(b) inserts regulation 26(17) into the 2005 regulations, which enables an operator to hold CERs and ERUs in its registry accounts.

	Emissions Trading Scheme in the first phase of the Scheme.	Regulation 27A(1) permits an operator to use CERs and ERUs to comply with its obligations to surrender allowances under the Scheme. Regulation 27A(2) makes an exception to this by providing that ERUs may not be used in the first phase.
Article 1(2) – inserting Article 11a(3) into Directive 2003/87/EC	Provides an exception to Article 11a(1) and 11a(2) so that CERs and ERUs generated from nuclear facilities and land use, land use change and forestry activities may not be used in the first and second phase of the Scheme.	Regulation 27A(3) provides an exception to reg 27A(1) that CERs and ERUs generated from nuclear facilities, land use, land use change and forestry activities may not be used by an operator to comply with its obligations under the Scheme.
Article 1(2) – inserting Article 11b(1) into Directive 2003/87/EC	Require that when Member States are approving Kyoto project activities to be undertaken in countries having signed an EU Treaty of Accession, they ensure that baselines for those project activities fully comply with the <i>acquis communautaire</i> including the temporary derogations set out in that Treaty of Accession.	Regulations 5-8 generally sets out the application procedure which an applicant must go through in order to obtain approval for a project activity. In particular, regulation 7(6)(a) provides that the Secretary of State may only approve a proposed project activity which is to be carried out in a country which has signed a Treaty of Accession where she is satisfied that the baseline complies with the bodies of common rights and obligations which bind Member States within the European Union subject only to the temporary derogations set out in that Treaty of Accession.
Article 1(2) – inserting Article 11b(2) into Directive 2003/87/EC	Requires that, apart from the exceptions in paragraphs 3 and 4, Member States are to ensure certain things when hosting project activities.	Regulation 7(5) prohibits the Secretary of State from approving a project activity to be carried out in the UK. The UK will therefore not host project activities, so the circumstances which

		Article 11b(2) seeks to avoid will not arise.
Article 1(2) – inserting Article 11b(3) into Directive 2003/87/EC	Provides an exception to Article 11b(2)	Does not require transposition as regulation 7(5) ensures that the situation giving rise to article 11b(2) will not arise.
Article 1(2) – inserting Article 11b(4) into Directive 2003/87/EC	Provides an exception to Article 11b(2)	Does not require transposition as regulation 7(5) ensures that the situation giving rise to article 11b(2) will not arise.
Article 1(2) – inserting Article 11b(5) into Directive 2003/87/EC	Requires Member States that authorises entities to participate in project activities to remain responsible for the fulfilment of its obligations under UNFCCC and Kyoto and shall ensure that such participation is consistent with the relevant guidelines, modalities and procedures adopted pursuant to the UNFCCC or Kyoto.	Regulation 7(7) prohibits the Secretary of State from authorising the participation of the applicant in a project unless she is satisfied that to do so would be consistent with Article 11b(5).
Article 1(2) – inserting Article 11b(6) into Directive 2003/87/EC	Requires Member States to ensure that certain criteria and guidelines are adhered to when approving hydro-electric power production project activities	Regulation 7(6)(b) prohibits the Secretary of State from approving such project activities unless she is satisfied that the relevant criteria and guidelines will be respected.
Article 1(2) – inserting Article 11b(7) into Directive 2003/87/EC	Sets out a procedure for adopting further provisions	Does not require transposition
Article 1(3) – replacing Article 17 of Directive 2003/87/EC	Requires certain information to made available to the public in accordance with Directive 2003/4/EC	Already transposed through Environmental Information Regulations 2004 (S.I. 2004/3391)
Article 1(4) – inserting new sub-paragraph in Article 18 of Directive 2003/87/EC	Requires co-ordination between body approving Article 6 project activities and Article 12 project activities.	Regulation 5 requires both types of application to be made to, and determined by, the Secretary of State. This ensures co-ordination.
Article 1(5) – inserting new sentence into Article 19(3) of Directive 2003/87/EC	Clarifies a Commission duty to adopt a Regulation	Does not require transposition

Article 1(6) – amending Article 21 of Directive 2003/87/EC	Sets out the subject matter which must be included in an annual Member State report to the Commission and places a duty on the Commission to organise an exchange of information	Does not require transposition
Article 1(7) – inserting new Article 21a into Directive 2003/87/EC	Requires Commission and Member States to endeavour to support capacity building activities in developing countries and countries with economies in transition	Does not require transposition
Article 1(8)(a) and (b) – amending Article 30(2)	Amends and expands upon the subject matter which must be covered by a report by the Commission.	Does not require transposition
Article 1(8)(c) – replacing Article 30(3), first paragraph	Requires each Member State to include details of its intended use of ERUs and CERs	Regulation 20 of the 2005 regulations requires the Secretary of State to develop a national allocation plan in respect of the second and subsequent scheme phase and to publish it at least 18 months before the beginning of the relevant phase. The definition of “national allocation plan” in regulation 2(1) of the 2005 regulations is amended so as to mean a plan developed in accordance with Articles 9, 10 and 30 of and Annex III to the Directive.
Article 1(8)(c) – replacing Article 30(3), second paragraph	Requires Member States to report to the Commission, and the Commission to report in consequence.	Does not require transposition
Article 1(9) – replacing Article 30(3), second paragraph	Inserts an additional criteria into Annex III, with which national allocation plans must comply	Already transposed through the 2005 regulations. Regulation 20 requires the Secretary of State to develop a national allocation plan in respect of the second and

		subsequent scheme phase. The definition of “national allocation plan” in regulation 2(1) of the 2005 regulations is a plan developed in accordance with Articles 9 and 10 of and Annex III to the Directive. In turn, “the Directive” is defined as meaning Directive 2003/87/EC as amended by Directive 2004/101/EC.
Article 2 and 3	Implementation and entry into force provisions	Does not need transposition

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Full Regulatory Impact Assessment

1. TITLE OF PROPOSAL

1.1 This Regulatory Impact Assessment (RIA) concerns the implementation of Directive 2004/101/EC of the European Parliament and of the Council (the “Linking Directive”), amending Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol’s project mechanisms.

1.2 Agreement on the Directive was reached on 27 October 2004, and it was published in the Official Journal on 13 November 2004².

1.3 This final RIA is in addition and supplementary to:

a) the draft initial RIA published with a consultation document on 8 September 2003, which can be found on the Defra website at:
<http://www.defra.gov.uk/corporate/consult/euets-link/index.htm>;

b) the partial RIA published with a consultation on draft Regulations for transposing the Linking Directive on 10 June 2005, which can be found on the Defra website at:
<http://www.defra.gov.uk/corporate/consult/euets-linkingdir/index.htm>.

1.4 This final RIA considers the options open to the UK in transposing Directive 2004/101/EC into law. In the consultation document accompanying the partial RIA, questions were asked and responses sought on issues relating to the options available in transposing the Directive. These relate to allowing Certified Emission Reduction units (CERs) into the first phase of the EU Emissions Trading Scheme (EU ETS), the impact any limit (quantitative or qualitative) on the total allowances permitted into the Scheme may have, and more complex issues relating to the banking of units between each Kyoto accounting period. These are considered in more detail below.

1.5 As the Linking Directive is concerned with linking Kyoto project mechanisms with the EU ETS, much of the analysis that follows takes the latter Scheme as its starting point³. An explanation of the EU ETS, the Kyoto Protocol and its project mechanisms and the Linking Directive may be found below at paragraphs 2.2.1-16.

² Directive 2004/101/EC is available from the European Commission website: http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2004/l_338/l_33820041113en00180023.pdf.

³ The full RIA on the EU ETS is available from:
http://www.opsi.gov.uk/si/em2005/uksiem_20051387_en.pdf.

2. PURPOSE AND INTENDED EFFECT

2.1 Objective

2.1.1 The aim of the proposal is to provide a way in which greenhouse gas emissions credits earned through the Kyoto flexible mechanisms can be used for compliance by operators of UK installations covered by the EU ETS, as set out in Directive 2004/101/EC. The Directive makes provision for Member States to allow the use of one type of project credit (CERs, or Certified Emission Reductions) in the first phase of the EU ETS (2005-2007), in order for operators covered by the EU scheme to comply with their obligations. In the second phase of the EU scheme (2008-2012) it makes provision for Member States to allow the use of both CERs and another type of project credit known as ERUs (Emission Reduction Units). This partial RIA only addresses the use of CERs in Phase I of the scheme, as the Directive allows decisions on Phase II use of CERs and ERUs to be made as part of the development of the Phase II National Allocation Plan, which will not be finalised until mid-2006. The proposal also provides for transposition of various requirements of the Directive that relate to project approval processes, and contains provisions relating to the national emissions inventory⁴. The Directive has to be transposed into UK law by 13 November 2005.

2.1.2 The intended effect of the proposal is to allow operators covered by the EU scheme to meet their obligations under the scheme in the cheapest and most flexible way possible over the first two phases (2005-2007 and 2008-2012), whilst ensuring that the environmental integrity of the scheme is maintained. It also aims to facilitate the benefits associated with the project mechanisms, in particular technology transfer to developing countries and more sustainable development in those countries. Finally, the proposal aims to put into place clear provisions on project approval processes and the collection of emissions data for the national emissions inventory, all by the transposition deadline of 13 November 2005.

2.2 Background

2.2.1 In order to understand the Regulations it is necessary to understand the international, EC and domestic law context of the Linking Directive. This section explains the challenge of climate change and outlines the Kyoto Protocol mechanisms and the EU Emissions Trading Scheme. It then goes on to explain the Linking Directive and how it links the Kyoto mechanisms and the European scheme.

⁴ Further details on the national emissions registry are available from: <http://www.naei.org.uk/>. The latest Greenhouse Gas Emissions Inventory report for the UK is available from: http://www.airquality.co.uk/archive/reports/cat07/0509211321_Reghg_report_2003_Main_Text_Issue_1.doc

Climate change

2.2.2 Climate change is one of the most serious environmental problems the world faces. Global average temperatures rose by 0.6°C during the 20th century, and the ten warmest years on record have occurred since 1990. All the evidence points to the primary cause being an increase in concentrations of greenhouse gases in the atmosphere due to human activities. The Intergovernmental Panel on Climate Change (IPCC) concluded in its Third Assessment Report⁵, published in 2001, that most of the observed warming over the last 50 years is attributable to human activities. The changing climate is likely to have far-reaching effects on all aspects of the world's environment, economy, society and health.

2.2.3 Further details of climate change and its impacts can be obtained from the IPCC and the UK Climate Impacts Programme⁶. Climate change impacts and adaptation issues are explored in more detail in the UK Climate Change Programme⁷ and in the Regulatory Impact Assessment that accompanied that document⁸.

2.2.4 The IPCC Third Assessment Report (2001) stresses the need for urgent action to tackle climate change and provides a sound basis for developing the national and international response.

The Kyoto Protocol and mechanisms

2.2.5 In response to the threat of climate change, most developed countries agreed at Kyoto in December 1997 to legally binding targets that will reduce emissions of the six main greenhouse gases by at least 5% below 1990 levels over the period 2008-2012. The resulting international agreement is known as the Kyoto Protocol, and commits countries listed in Annex I to the UN Framework Convention on Climate Change (UNFCCC) and with commitments inscribed in Annex B to the Protocol to reducing emissions of greenhouse gases by specific amounts over the period 2008 – 2012 (the “first commitment period”).

2.2.6 The EU and its twenty five member states are parties to the Kyoto Protocol. The European Community and its member states have agreed to an 8% reduction from 1990 emissions. In June 1998, the then fifteen member states agreed to share out the European Community's target and as part of this burden-sharing agreement the UK agreed to reduce its emissions by 12.5% from 1990 levels⁹. As part of its Climate Change Programme the UK also adopted an ambitious national goal of achieving a 20% reduction on 1990 levels of carbon dioxide (CO₂) by 2010. In the 2003 Energy White

⁵ Available from: <http://www.ipcc.ch/>

⁶ See: <http://www.ukcip.org.uk/>

⁷ See: <http://www.defra.gov.uk/environment/climatechange/cm4913/>

⁸ See Annex I: <http://defra.gov.uk/environment/climatechange/cm4913/pdf/section5.pdf>

⁹ Council Decision 2002/358/EC concerning the approval, on behalf of the European Community, of the Kyoto Protocol to the United Nations Framework Convention on Climate Change and the joint fulfilment of commitments thereunder.

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Paper¹⁰ the Government stated its intention to put the UK on a path to a reduction in CO₂ emissions of some 60% by about 2050, with significant progress by 2020.

2.2.7 The Kyoto Protocol sets a framework for the reduction of greenhouse gas emissions. Further detailed rules were agreed in Marrakesh in 2001 and subsequently. The collection of decisions setting out the detailed rules are known collectively as the “Marrakesh Accords”.¹¹

Flexible Mechanisms

2.2.8 The Kyoto Protocol also provides for flexible mechanisms that should allow Governments and industry to achieve emissions reductions at least cost. The mechanisms include international emissions trading (IET)¹², and two project-based mechanisms, known as Joint Implementation (JI)¹³ and the Clean Development Mechanism (CDM).¹⁴ The detailed rules for the operation of the flexible mechanisms are set out in the Marrakesh Accords.

2.2.9 The project mechanisms enable project credits to be obtained for reducing emissions in another country. These project credits can then be used to meet targets under the Kyoto Protocol. The rationale for these mechanisms is that as greenhouse gases are emitted into the atmosphere they will result in a contribution to global increases in temperature, regardless of the source. It is therefore necessary to control greenhouse gas emissions at a global level and it makes sense to make reductions where it is most efficient and cost effective to do so. The flexible mechanisms address this by encouraging the reduction of emissions at the lowest cost location.

Joint Implementation

2.2.10 Joint Implementation (JI) is a project based mechanism carried out between two countries with Kyoto commitments and hence tradeable allowances, called Assigned Amount Units (AAUs). One country can carry out a project to reduce the emissions of a host country. The reductions can then be quantified (compared to a business-as-usual scenario) and an appropriate amount of credits transferred from the host country to the sponsor in the form of emission reduction units (ERUs). In this situation the sponsor country gets extra allowances, allowing them to increase their emissions, while the project will result in a reduction in emissions in the host country by an amount equal to the allowances transferred, so the loss of the allowance neither makes it easier nor harder for the host to meet their commitment. ERUs will not be available until 2008 at the earliest, and their use is therefore not considered in this partial RIA. Work on the development of the National Allocation Plan for

¹⁰ See: <http://www.dti.gov.uk/energy/whitepaper/index.shtml>

¹¹ The majority of the rules agreed at Marrakesh are in the form of draft rules which are expected to be adopted when the Parties to the Kyoto Protocol meet later this year. Please see: http://unfccc.int/cop7/accords_draft.pdf for further details.

¹² Article 17 of the Kyoto Protocol.

¹³ Article 6 of the Kyoto Protocol.

¹⁴ Article 12 of the Kyoto Protocol.

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Phase II of the EU ETS (2008-2012) will address the use of these credits from 2008 onwards.

Example of a JI project

The upgrade of a cardboard plant at Nikopol in Bulgaria will reduce emissions of CO₂e (carbon dioxide equivalent) by incorporating multicomponent energy efficiency measures and a change to a greener fuel source. These measures are being implemented from 2004-8, and over the period 2008-12 an estimated savings of 372,539tCO₂e will be made, thereby generating a similar amount of ERUs. This will provide the multinational paper company that owns the plant with a low cost option for compliance with the EU ETS, while generating cost savings at the plant itself.

The Clean Development Mechanism

2.2.11 The clean development mechanism (CDM) is similar to JI except that the host country does not have a Kyoto commitment and hence does not have allowances to transfer. Credits (certified emission reductions, CERs) can be generated by reducing emissions relative to a very carefully monitored baseline (business-as-usual scenario). Once generated, the CERs can be transferred to the sponsoring country, to be used for compliance with their Kyoto commitment. The CDM is the only part of the Kyoto Protocol to include developing countries, which see it as a very useful way of contributing to their sustainable development and gaining access to investment and more advanced technologies.

2.2.12 The CDM benefits from a prompt start under international rules, and CERs are expected to be available for use from 2007.

Example of a CDM project in China

The installation of thirty 1500kW wind turbines near Manjing village, Zhangbei, China to create a 45MW wind farm will deliver around 108 GWh of energy per year, reducing greenhouse gases in China as well as other pollutants such as sulphur and soot, compared to the 'business as usual' scenario. The project will help stimulate growth of wind power in China, and create local employment in terms of assembly, installation and operation of the plant.

Over the period 2006-16 it is expected that this project will generate nearly 1 million CERs. The buyer is likely to be an EU ETS participant and as such these credits provide a low cost option for compliance.

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Supplementarity

2.2.13 By imposing express emissions limits only on Annex I countries, the Kyoto Protocol requires developed countries to take the lead in reducing emissions of greenhouse gases. This is reinforced by the requirement in the Marrakesh Accords stating that ‘the use of the mechanisms shall be supplemental to domestic action and that domestic action shall thus constitute a significant element of the effort made by each Party...’¹⁵. This is primarily to demonstrate to developing countries that industrialised countries are willing to take positive action domestically and make real efforts to reduce their own emissions, rather than expecting others to make the reductions and buying credits from overseas to meet their obligations. The requirement that the use of the project mechanisms is supplemental to domestic action is known as the “principle of supplementarity”. However, there is no agreed definition between member states as to what would constitute supplementary use of the flexible mechanisms.

EU Emissions Trading Scheme

2.2.14 The EU Emissions Trading Scheme (EU ETS) forms an integral part of the EU’s strategy to meet its target and tackle the challenges posed by climate change. Its purpose is to deliver reductions in greenhouse gas emissions in a more cost-effective way.

2.2.15 The scheme includes all 25 EU member states. It covers around 12000 installations such as power stations, factories, cement kilns and iron and steel works across the EU¹⁶, and will allow company-level trading between member states. Each country sets a ‘cap’ or limit on the total number of emissions allowances (EUAs, or EU allowances, each equivalent to one tonne of CO₂) that will be given to the regulated sector. This cap is below the projected business-as-usual emissions for this sector (i.e. the amount of CO₂ that would have been emitted in the absence of the scheme). The UK’s cap for Phase I is 736m allowances, compared with projected emissions of 783m tonnes CO₂.¹⁷ Within the UK, roughly 1100 installations are covered by the EU ETS and they account for 46% of our national emissions of CO₂.

2.2.16 Within each members states’ total cap, operators are provided with allowances, which permit them to emit a certain amount of greenhouse gases. They have to surrender allowances in line with their actual emissions at the end of each year, or they face a fine. Further details of monitoring and enforcement are given in section 8. If one operator is finding it comparatively cheap to make reductions, they can sell any unused allowances to other

¹⁵ Decision 15 of the Conference of the Parties 7th session (15/CP.7), available at: <http://unfccc.int/resource/docs/cop7/13a02.pdf> - page=2.

¹⁶ For further information on the EU ETS please see the Defra website: <http://www.defra.gov.uk/environment/climatechange/trading/eu/index.htm>.

¹⁷ The UK has proposed an amendment to the NAP to allocate 756.1 million allowances. However the Commission has to date only approved the UK to allocate 736.3 million allowances. The allocation of the additional 19.8 million allowances is the subject of a legal challenge. Without prejudice to this challenge an initial allocation of 736.3 million allowances will be made.

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operators – any of the EU's member states – who may be finding it relatively more expensive to limit their emissions. Thus carbon dioxide emissions are reduced across the EU, but at the lowest cost. Carbon allowances are currently trading at around €20-25 per allowance (i.e. per tonne of CO₂). Following the start of the scheme earlier this year the market across Europe has grown considerably, but it is too early to say whether UK operators will be net buyers or sellers of credits.

2.2.17 The EU ETS is central to the UK's efforts to move towards a low carbon economy. It is a key measure in helping us to meet our 20% domestic emission reduction goal by 2010 and international commitments to reduce emissions of greenhouse gases.

The Linking Directive

2.2.18 The Linking Directive¹⁸ envisages enabling operators within the EU ETS to use credits obtained for emission reductions through the Kyoto project based mechanisms for compliance with their commitments under the EU ETS. This is likely to reduce compliance costs (by providing increased flexibility in meeting targets to operators) and encourage investment in cheaper emission reductions within the EU and beyond. The Directive also contains various technical provisions relating to the approval of projects.

2.3 Rationale for Government intervention

2.3.1 This full RIA refers to the Government's Regulations for implementing the Linking Directive in the UK. It is mandatory for the Government to transpose the Directive into UK law and to do so by 13 November 2005. If the UK does not implement the Directive by the required date, it risks having infraction proceedings brought against it by the European Commission.

Kyoto Protocol obligations

2.3.2 In the Kyoto Protocol and the Marrakesh Accords the UK signed up to the flexible mechanisms. The CDM is the only Kyoto mechanism to include developing countries. If member states were to decide not to allow credits from the CDM into the EU ETS, the benefits which host countries are set to receive from the CDM would be reduced, and it could negatively affect the engagement of developing countries in international action on climate change. JI provides for similar benefits to developed countries, in particular those which may not immediately establish emissions trading schemes to link to the EU ETS such as Russia and the Ukraine.

2.3.3 Access to the flexible mechanisms will ensure that UK business can comply with their obligations under the EU ETS as cost-effectively as possible. By providing flexibility to choose how to meet their commitments in the cheapest manner, we are ensuring that we do not put UK business at

¹⁸ Available from: http://europa.eu.int/comm/environment/climat/emission/pdf/dir_2004_101_en.pdf

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undue competitive risk from foreign businesses that operate in other EU countries who may also make use of these flexible mechanisms.

2.3.4 Care will need to be taken to ensure that the only credits allowed into the EU ETS are those that represent real and additional reductions particularly by ensuring that counterfactual (i.e. without the project) baselines have been estimated accurately. For a CDM project poor estimations of the baseline or business-as-usual scenario could result in emissions rising in a developed country without an equivalent level of reductions in the host country. The UN has set up a CDM Executive Board to ensure that considerations of this type are taken fully into account when planning CDM projects.

2.3.5 There is currently uncertainty regarding final levels of delivery of credits, and supply may be slow. Approved projects are dominated by a few large players and are primarily non-CO₂ projects (partly due to methodological issues concerning additionality), although projects further along the pipeline are being developed by a diverse range of developers and organisations. In particular the pace of progress at the CDM Executive Board and delays in implementation of registry systems mean that credits are unlikely to become available until late in the first phase of the EU ETS. The latest estimation for linking of registry systems is early in 2007. So far twenty five projects worldwide have been approved by the Executive Board, and in October 2005, 63 further projects are under validation (i.e. at the pre-approval stage)¹⁹.

3. CONSULTATION

3.1 Within Government and the Devolved Administrations

3.1.1 The Department for Environment Food and Rural Affairs (Defra) is working closely with the Department of Trade and Industry (DTI) and the devolved administrations of Scotland, Wales and Northern Ireland on the implementation of the EU ETS. HM Treasury, the Department for Transport, the Cabinet Office, the Foreign and Commonwealth Office and the UK Permanent Representation in Brussels (UKREP) are also consulted regularly on policy issues²⁰.

3.1.2 Close dialogue is also held between Government, the devolved administrations and agencies involved in regulating the EU ETS; namely the Environment Agency; Scottish Environment Protection Agency and Department of the Environment in Northern Ireland.

¹⁹ See <http://cdm.unfccc.int/Projects/registered.html> and <http://cdm.unfccc.int/Projects/pac/howto/CDMProjectActivity/Validate> for further information on projects registered to date and the project approval process.

²⁰ Regulation 46 of the Greenhouse Gas Emissions Trading Scheme Regulations 2005 contains express provisions regarding the agreement of the devolved administrations in relation to the exercise of certain powers by the Secretary of State.

3.2 Public Consultation

3.2.1 Stakeholders, including business and non-governmental organisations, are regularly consulted on the implementation of the Scheme and their responses have been used to inform policy decisions with regard to the development of the National Allocation Plan. A list of all consultations that have been held on the EU ETS to date is available on the Defra website:

<http://www.defra.gov.uk/environment/climatechange/trading/eu/info/consultations.htm>.

3.2.2 A public consultation on the draft Regulations for the transposition of the Linking Directive was held between 10 June and 19 August 2005. The results of the consultation have been taken into account by officials and Ministers in making the final decisions on how to transpose the Directive into UK law. The consultation paper and accompanying documents can be found at the link given in paragraph 3.2.1.

4. OPTIONS

4.1 Use of CERs in Phase I of the EU ETS

4.1.1 Use of CDM credits by operators within the EU ETS would allow an increase in CO₂ emissions by operators of UK installations, through direct UK operator use of CDM credits, or indirectly via the availability of allowances within the EU ETS market as a result of use by operators outside the UK. Any increased emissions of CO₂ within the EU may be offset by emission reductions over a range of greenhouse gases outside the EU.²¹

4.1.2 However, as discussed below CERs are currently cheaper than EUAs which means UK operators may prefer to buy CERs instead of EUAs to cover the difference between their CO₂ emissions and their Phase I allowances, without there being an actual increase in CO₂ emissions.

Option 1: Do not allow use of CERs in Phase I

Costs

4.1.3 Forward contracts for delivery of CERs are currently around €6-12, although this is an estimated range as CER price data is not readily available. This can be due to the fact that prices are often not publicly disclosed; to differences in the price reporting practices of buyers; and because prices vary widely according to the type of contract being traded. Contracts will vary for

²¹ The Kyoto Protocol covers a basket of six gases that contribute to global warming: carbon dioxide (CO₂), methane (CH₄), nitrous oxide (N₂O), sulphur hexafluoride (SF₆), perfluorocarbons and hydrofluorocarbons. (see

http://unfccc.int/essential_background/kyoto_protocol/background/items/1351.php). Of these, carbon dioxide accounted for around 86% of weighted UK emissions of greenhouse gases in 2003 (see page 25 of the UK Greenhouse Gas Inventory, 1990-2003 available from: http://www.airquality.co.uk/archive/reports/cat07/0505171543_ukghgi_90-03_Issue_1.0.doc).

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example according to the type of project being undertaken and the share of project risk between the buyer and the seller. The current price of CERs reflects the market assessment of project, delivery and political risks attached to the CDM. However as CERs can be banked into the second and third phases of the EU ETS they will provide further flexibility for operators and may therefore eventually trade at a premium in the first phase.²²

4.1.4 The current price of EUAs for delivery in 2005, 2006 and 2007 is approximately €22, although this is expected to fall to around €10-15 by the end of Phase I²³. Given these current figures, a typical price differential for CERs and EUAs in Phase I might be around €13. If this price differential between the cost of EUAs and CERs remains, then not allowing the use of CERs in Phase I will mean operators will be denied access to potentially cheaper credits.

4.1.5 The UK cap for Phase I has been set at 736mtCO₂, roughly 6% below business-as-usual emissions of 783mtCO₂. This equates to a shortfall in Phase I of 47mtCO₂. Research jointly commissioned by Defra and DTI suggests that global supply of CERs will be approximately 90mt over Phase I. If a quantitative limit is set at 10% of the Phase I cap, then this would allow UK operators to buy about 72m CERs for compliance use during Phase I, i.e. more than they need. This means that Option 1 effectively sets “no limit”.²⁴

4.1.6 CERs are not expected to be available until the final year of Phase I (2007). Assuming a price differential of €13, the additional cost to UK operators of compliance with their EU ETS obligations in this year caused by lack of access to these cheaper credits would be around €208m. Assuming a lower price differential of €5, the cost would be €80m. With a price differential of only €2, the additional cost to UK operators in 2007 would be €32m. With no price differential between the two types of allowances, there would be no additional cost to operators²⁵.

²² See http://www.pointcarbon.com/wimages/CJM_09_08_2005_sdkfb.pdf for information on recent trades of CERs and their attendant prices.

²³ Recent EUA prices have been quite high relative to the expected range of €10-15. A possible reason for this is the recent increase in global oil and gas prices, resulting in power generators using more coal and hence emitting higher levels of CO₂. Cold spells across Europe have also increased demand for power and thus allowances. Finally uncertainty in this new market and low liquidity may explain why prices have been relatively high. As the market matures, we expect that prices may fall back down to the €10-15 range. See http://www.pointcarbon.com/wimages/CMD16_08_05.pdf for further information.

²⁴ Note that in the analysis of quantitative limits, we have specified limits to be a “percentage of 2007 annual allocation”. This is because at present, CERs are not expected to be delivered until that year and hence we do not expect operators to be able to use CERs for compliance until 2007.

²⁵ For estimates of cost and benefit throughout this partial RIA, it is assumed that UK operators will choose to meet any shortfall of allowances by first buying CERs, as these are currently cheaper than EUAs, and that EUAs are the same cost as internal abatement (so that the benefit of buying CERs compared with either purchasing allowances or internal abatement is the same). In reality shortfalls will be met via a combination of these methods depending on the availability and price of CERs and EUAs and the cost and availability of internal abatement measures. Operators will only choose to abate if this is lower cost than purchasing EUAs, i.e. if they can abate and have a financial benefit from being able to sell surplus allowances or avoiding the purchase of EUAs. Assuming that the use of CERs will be the lowest cost method for meeting any shortfalls, and that abatement is the same cost as buying EUAs gives a maximum potential benefit of allowing operators to use these credits to meet their EU ETS targets (or maximum potential cost of preventing this use).

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4.1.7 Other member states intend to allow for use of CERs in the first phase. If UK operators are not allowed to use CERs and if CERs are cheaper than EUAs, the benefits of the increased supply in allowances will therefore accrue to non-UK operators via an arbitrage situation. Operators in other member states could buy in relatively cheap CERs to comply with their obligations and sell on their more expensive EUAs to UK operators. Removing the option of offsetting emissions via JI and CDM would mean UK operators are more limited in the choice and flexibility of meeting their compliance obligations.

4.1.8 Several UK companies have substantial investments in CDM projects. Preventing access to CERs would decrease the potential market for these credits, although they would still be able to sell them to operators in other member states, to governments and to buyers outside the EU.

Benefits

4.1.9 By not allowing the use of CERs by UK operators during Phase I the impact of the EU ETS on domestic (EU) CO₂ reductions may be enhanced. UK companies will be forced to make emission reductions themselves, or will buy allowances (EUAs) from within the EU.

Option 2: Allow the use of CERs in Phase I

Costs

4.1.10 The EU ETS has been identified in the 2003 Energy White Paper as the main plank of UK policy for the delivery of CO₂ reductions. Use of allowances from within the EU (i.e. EUAs) already provides for UK business to increase CO₂ emissions through purchasing allowances abroad. Allowing the unrestricted use of CERs – apart from the mandatory exclusions required by the Directive – will increase this potential. It is important to note that offsetting via the use of credits will reduce the EU ETS contribution to CO₂ reductions in the EU, whereas the use of allowances from other EU countries does not affect the level of CO₂ reductions achieved within the EU as a whole. It would be difficult to quantify the cost of this impact on the UK's CO₂ 2010 and 2050 abatement targets in any meaningful way, as the costs would be environmental and political (less abatement of CO₂ by the UK) rather than an economic cost to operators.

4.1.11 Allowing UK operators to use CERs may also increase the demand for them, and their price, thereby increasing the cost of implementing any public procurement of offset credits.

Benefits

4.1.12 Providing for the use of CERs in Phase I would show support for the use of the Kyoto Project mechanisms and encourage further investment by UK companies in developing projects in developing countries. It could also

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provide learning-by-doing benefits for Phase II. Deciding not to use CERs would send a negative signal in respect of the Government's support of the CDM.

4.1.13 By providing access to the EU ETS for CERs from the CDM, the overall market size for CERs will be increased as demand for CERs will be higher. The associated benefits to developing countries in terms of technology transfer and their sustainable development will also be increased.

4.1.14 As noted at paragraph 4.1.2, CERs are currently cheaper than EUAs and so could provide cost savings through two routes. First, by UK operators buying CERs in preference to EUAs while CERs are cheaper and second by reducing the cost of EUAs as a result of the increased supply of compliance credits. Estimates of the possible cost saving for UK operators covered by the EU ETS based on just the price differential range between €0 and €208m, depending on what assumptions are made about the price differential in 2007 between CERs and ERUs, the demand for allowances from UK operators and the global supply of CERs. It is not possible to estimate the price effect on EUAs as this is a dynamic effect, which is very hard to predict, and depends on the demand for allowances in 2007, which will be influenced by a wide range of factors. The estimated costs set out at paragraph 4.1.3 are the same as the benefits that operators would accrue if unlimited use of CERs were to be allowed in Phase I. By buying CDM credits rather than EUAs a company also has the option of using the credits for compliance in Phase I, or banking them for use in Phase II.

4.1.15 As noted above in paragraph 2.3.5, there is uncertainty over the timely release of credits within the Phase I timeframe due to the lengthy process of verifying and approving CDM projects, and uncertainty regarding linking of registry systems. This means that any credits that do become available may not do so until towards the end of Phase I, which reduces the benefit of allowing credits in Phase I. However, this is also likely to be the time when CERs are of most value because of the flexibility provided by them across the phase boundaries, as mentioned in paragraph 4.1.10

4.2 Limits on the use of CERs in Phase I

4.2.1 The Directive requires that a quantitative installation-level limit is set on use of CERs in the second phase of the EU ETS, which will run from 2008 to 2012 (Article 11a(1)). If CERs are to be allowed to be used in Phase I, a decision is needed on whether there should be a qualitative or quantitative limit. There are arguments for and against having a quantitative limit in the first phase, in anticipation of Phase II obligations.

4.2.2 A quantitative limit would place a restriction on the amount of CERs allowed in Phase I, and CERs and ERUs in Phase II. A qualitative limit would restrict access to credits from certain types of CDM or JI projects, for example those that reduce emissions of certain non-CO₂ greenhouse gases.

4.2.3 Current UK domestic policy prioritises CO₂ reduction through its 20% CO₂ emissions reduction goal, and the Energy White Paper identifies the EU ETS as the major policy for delivery of this target.

4.2.4 In the 2000 Climate Change Programme²⁶ the Government proposed that credits obtained via the mechanisms would count towards the national CO₂ goal, though the details were not expanded. If non-CO₂ gases were to be allowed into the scheme in Phases I and / or II, this would raise questions regarding the EU ETS contribution to national targets. These are issues that will be considered as part of the current review of the Climate Change Programme.

4.2.5 A decision to allow non-CO₂ gases from outside the EU into the scheme in the first phase might pre-empt decisions on non-CO₂ inclusion more broadly in the second phase.

Option 1: Impose a quantitative limit

Costs

4.2.6 Depending on the relative prices of CERs and EUAs, imposing a quantitative limit on the number of CERs that may be used to meet compliance requirements in the EU ETS could be at the expense of cheaper compliance options for UK operators. This may be seen as imposing additional costs on UK business relative to their EU competitors.

4.2.7 Other member states have indicated that they are unlikely to impose any limits on the use of CERs in Phase I beyond those on credits from nuclear and forestry projects that are required by the Directive. As discussed above, this would mean that any benefits of increased supply in allowances would accrue to non-UK operators if a quantitative limit were to be imposed at the UK level alone.

4.2.8 The three options below estimate the costs and benefits to UK operators of three levels of quantitative limit, ranging from very loose to relatively stringent.

Option 1.1 – “no limit”

This option looks at setting a limit that will not bite on UK operators, effectively allowing them to buy enough CERs to meet the shortfall between their Phase I allocation and Phase I actual emissions without reaching the limit set²⁷.

²⁶ See: <http://www.defra.gov.uk/environment/climatechange/cm4913/>

²⁷ The UK cap for Phase I has been set at 736mtCO₂, roughly 6% below business-as-usual emissions of 783mtCO₂. This equates to a shortfall in Phase I of 47mtCO₂. Research jointly commissioned by Defra and DTI suggests that global supply of CERs will be approximately 90mt over Phase I (2005-07). If a quantitative limit is set at 10% of the Phase I cap, then this would allow UK operators to buy about 72m CERs for compliance use during Phase I i.e. more than they need. This means that Option 1 effectively sets “no limit”. Note that in the analysis of quantitative limits, we have specified limits to be a “percentage of 2007 annual allocation”. This is because at present, CERs are not expected to be

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Benefits

If we assume that global supply is sufficient to meet UK demand, the UK will buy 47m CERs as opposed to EUAs. With no price differential between the two types of allowances, there would be no benefit to operators. If the price of CERs turns out to be €2 cheaper than EUAs, then the potential benefit to UK operators in 2007 would be €94m. A price differential of €5 would lead to a benefit of €235m. With the current price differential of about €13, benefits increase significantly to €611m. This is summarised below in Table 1.

Table 1: Benefits of “no limit” according to EUA/CER price differentials

Estimated demand	Benefits according to the following EUA/CER price differentials		
	€2	€5	€13
47 MtCO ₂	€94m (£64m)	€235m (£160m)	€611m (£415m)
23 MtCO ₂	€46m (£31m)	€115m (£78m)	€299m (£203m)
10 MtCO ₂	€20m (£14m)	€50m (£34m)	€130m (£88m)

Costs

Any benefits that accrue to operators needs to be balanced against the fact that the use of CERs may partially offset domestic CO₂ emissions reductions, slowing progress towards our 20% domestic CO₂ target due to a lower level of emission reductions than would otherwise have been the case.

Option 1.2 – loose limit: 6.4% limit of UK cap

Option 1.2 considers setting a limit that allows UK operators to buy an amount approximately equal to their shortfall of allowances. Since the Phase I shortfall is approximately 47MtCO₂, this translates to a limit on the use of CERs of 6.4% of the Phase I cap.

Benefits

The benefits of this option according to EUA/CER price differentials are the same as those for option 1.1. In addition, there may be presentational benefits in the UK imposing a limit, albeit one that does not “bite”.

Costs

The costs of this option are the same as those for option 1.1.

delivered until that year and hence we do not expect operators to be able to use CERs for compliance until 2007.

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Option 1.3 – 1.7% limit corresponding with 12.5% Kyoto target

Option 1.3 looks at the UK's 1990 emissions of CO₂ and applies the 12.5% Kyoto target to this figure to see what emission reductions are required to meet this target, solely through CO₂ reductions, in 2010²⁸. For CO₂ emissions to be 12.5% below 1990 levels, emissions would have to be 531MtCO₂ in 2010. 2004 CO₂ emissions are estimated to be 581MtCO₂, meaning that a reduction of 50MtCO₂ is required between the end of 2004 and 2010 to meet the target. The EU ETS covers approximately 46% of UK CO₂ emissions. If we apply this percentage to the 50Mt, this gives us a figure of 23MtCO₂ that we might expect UK operators of the scheme to contribute to the target reduction over the period 2005-2010. Spreading this reduction equally across the period 2005-2010 equates to a per year reduction of approximately 4MtCO₂, and hence 12 MtCO₂ over the Phase I period.

From this, a reasonable limit on the use of CERs could be set at 1.7% of the Phase I cap which would allow UK operators to buy enough CERs to match the 12Mt reduction. UK operators would then buy 35m EUAs to cover the remainder of their 47Mt shortfall in Phase I.

Benefits

With a price differential of €2, the benefits of allowing some use of CERs would be €24m in 2007. A price differential of €5 would lead to a benefit of €60m. With the current price differential of about €13, benefits increase to €156m.

Costs

As with option 1.1, there will be costs associated with a lower level of emissions reduction than would likely occur in the absence of CER use. However, these costs would be lower than under option 1.1. The extent to which this will be the case depends on how the price of EUAs compares with internal abatement costs.

Benefits

4.2.9 Where supply is greater than demand, a limit would ensure a higher price of carbon, and thus prevent the incentive to reduce CO₂ emissions domestically being reduced by offsets from reductions of CO₂ and non-CO₂ greenhouse gases abroad. More specifically, a limit could also prevent a potential influx of cheap non-CO₂ credits undermining the EU ETS contribution to meeting the national CO₂ reduction target (see below on qualitative limits).

²⁸ Calculations in this section have been made using data from Defra's "Provisional 2004 UK climate change sustainable development indicators and 2003 air pollutant emissions final figures", available at: <http://www.defra.gov.uk/news/2005/050331a.htm>

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4.2.10 In the shorter term it is more likely that supply will be less than demand, given the currently slow rate of progress at the CDM Board in getting projects registered, and delays in development of the International Transaction Log which is required to authorise transactions. If there is an undersupply of cheaper CDM credits and concentration in the market on the supply side, a limit per installation would ration supply between operators, promote competition by reducing the dominance of large buyers and sellers in the market, and facilitate more general access to these cheaper credits.

4.2.11 Introduction of a relatively loose limit in Phase I could also provide useful experience in the use of a limit in practice, prior to the legal requirements for Phase II.

4.2.12 A binding quantitative limit should reduce import of non-CO₂ related credits to the UK, and maximise the contribution of the EU ETS to the delivery of CO₂ reduction within the UK and EU. It would be less effective in ensuring delivery of CO₂ reductions than a policy that directly targeted non-CO₂ gases, as credits originating from non-CO₂ projects would still be allowed within the scope of the EU ETS, up to the level dictated by any quantitative limit.

4.2.13 It would reduce any risks of damaging incentives to abate domestically and maintain the positive impact of the EU ETS on technological development in abatement in the UK. Setting a limit would demonstrate the UK's commitment to climate change issues and would support the Energy White Paper commitment to an early move towards a low-carbon economy. It would indicate that the UK is serious about reducing emissions domestically and does not intend to use project credits as a way of avoiding abatement action.

4.2.14 Table 2, below, summarises the benefits of the various quantitative limit options discussed above.

Table 2: Summary of benefits of various quantitative limits

Option	Benefits according to the following EUA / CER price differentials		
	€2	€5	€13
Option 1.1: "no limit"	€94m (£64m) ²⁹	€235m (£160m)	€611m (£415m)
Option 1.2: "loose limit"	€94m (£64m)	€235m (£160m)	€611m (£415m)
Option 1.3: 1.7% limit	€24m (£16m)	€60m (£41m)	€156m (£106m)

²⁹ Figures in brackets show benefits in pounds sterling using an exchange rate of €1 = £0.68. Figures may not convert exactly due to rounding.

Option 2: Impose a qualitative limit

4.2.15 A decision is also needed on whether any qualitative limits should be imposed, such as excluding the use of non-CO₂ credits in the EU ETS. The Directive already requires the exclusion of credits from nuclear, land-use, land-use change and forestry (LULUCF) projects. In addition to this there could be an argument for the exclusion of non-CO₂ gases in the first phase. Non-CO₂ gases currently represent around two-thirds of the identified market by volume. The costs and benefits of the use of non-CO₂ related credits for Phase I are set out below.

Costs

4.2.16 Setting a qualitative limit on the use of CERs/ERUs that may be used to meet compliance requirements in the EU ETS, would reduce the range of compliance options available to UK operators. This would be expected to increase costs to UK operators since supply is essentially reduced. However, the actual impact depends on the limits imposed by other Member States.

4.2.17 Depending on the relative prices of CERs and EUAs, imposing a qualitative limit could be at the expense of cheaper compliance options for UK operators. This may be seen as imposing additional costs on UK business relative to their EU competitors. There could therefore be an effect on the competitiveness of UK industry relative to the EU.

Benefits

4.2.18 Although the issue is dependent on decisions about inclusion of CERs in Phase I and about the use of CERs and ERUs in Phase II, the exclusion of CERs from non-CO₂ projects in Phase I would not create a binding precedent which effectively makes a decision on Phase II expansion. By contrast, it might be difficult to exclude non-CO₂ gases in Phase II if they were included in Phase I. One benefit of excluding CERs from non-CO₂ projects in Phase I, therefore, is that it would remove the potential cost of such a precedent for Phase II.

4.2.19 As the decision on the Phase II cap is not due to be made until later this year, this option raises timing issues. The supply of credits in Phase II will be affected by the decision on the limits on CERs and ERUs.

4.2.20 Use of non-CO₂ credits could reduce the contribution of the EU ETS to national CO₂ goals, as EU ETS operators may comply through CDM credits from non-CO₂ gases, particularly if these credits are cheaper than EUAs. A qualitative limit would exclude non-CO₂ related credits from the UK, supporting the contribution of the EU ETS to the delivery of CO₂ reduction targets within the UK and could stimulate investment in CO₂ projects abroad.

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4.2.21 As in paragraph 4.2.10 above, the “learning by doing” argument applies as the introduction of an exclusion in Phase I could be used to see how it operates in practice, prior to Phase II.

4.2.22 The three options below estimate the costs and benefits to UK operators of three levels of quantitative limits used in conjunction with a qualitative limit.

Option 2.1: qualitative limit plus “no quantitative limit”

This option disallows the use of non-CO₂ CERs and also sets a quantitative limit on the use of CO₂ CERs which doesn't bite. A limit of 5% of the Phase I cap would allow operators to buy the maximum possible amount of CO₂ CERs available to them i.e. 30M³⁰ without actually reaching the imposed limit. With the Phase I shortfall estimated to be 47Mt, UK operators would buy 30M CO₂ CERs and 17M EUAs in Phase I.

Benefits

With a price differential of €2, the benefits of the allowing unlimited use of CO₂-CERs would be €60m. This compares with €94m when no qualitative limit is set. With a price differential of €5, the benefit increases to €150m compared with €235m when no qualitative limit is set. With a price differential of €13, the benefit is €390m compared with €611m when no qualitative limit is set.

Costs

There would be costs associated with a lower level of emissions reduction being achieved than would likely occur in the absence of CER use. However, these costs would be lower than under option 1 above where no quantitative or qualitative limit is set.

If CERs are cheaper than EUAs in Phase I, then setting a qualitative limit may lead to competitiveness impacts for UK operators. Operators will not have full access to CERs whereas competitors elsewhere in the EU would (assuming other Member States do not impose any limits). The extent of any such competitiveness impacts are uncertain.

Option 2.2: qualitative limit plus “4.1% loose limit”

This option disallows the use of non-CO₂ CERs and also sets a quantitative limit on the use of CO₂ CERs which allows operators to buy an amount equal to their Phase I shortfall of 47M. Since the supply of CO₂ CERs in Phase I is only 30M, this means setting a limit that allows operators to use 30M CERs for compliance in Phase I. A limit of 4.1% of the Phase I cap would allow this

³⁰ Research by Ecofys shows that global supply of CERs for Phase I is about 90Mt, a third of which are CO₂ credits. If a qualitative limit is set to disallow the use of non-CO₂ CERs, then the maximum possible supply of CERs available to UK operators in Phase I would be approximately 30Mt.

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amount to be bought. UK operators would buy 30M CO₂ CERs and 17M EUAs in Phase I.

Benefits

The benefits of this option are the same as those for option 2.1.

Costs

The costs of this option are the same as those for option 2.1.

Option 2.3 – 1.7% limit corresponding with 12.5% Kyoto target

This option disallows the use of non-CO₂ CERs. It also sets a quantitative limit that allows UK operators to buy enough CERs to approximately match a 12Mt reduction of CO₂ emissions in Phase I (see *Option 3* in the quantitative limits section above). A limit of 1.7% of the Phase I cap would allow operators to buy this amount on CO₂ CERs. UK operators would buy 12m CO₂ CERs and 35m EUAs in 2007.

Benefits

With a price differential of €2, the benefits would be €24m. With a price differential of €5, the benefit increases to €60m. With a price differential of €13, the benefit is €156m.

Costs

The same types of costs as under option 2.1 would occur but to a lesser extent.

If CERs are cheaper than EUAs in Phase I, then this option will incur competitiveness costs for UK operators compared to options 2.1 and 2.2. Operators will not have full access to CERs whereas competitors elsewhere in the EU would (assuming other Member States do not impose any limits). The extent of any such competitiveness impacts are uncertain.

4.2.23 Table 3 summarises the relative benefits of options 2.1, 2.2 and 2.3.

Table 3: Qualitative and quantitative limits

Option	Benefits according to the following EUA / CER price differentials		
	€2	€5	€13
Option 2.1: qualitative plus "no quantitative limit"	€60m (£41m) ³¹	€150m (£102m)	€390m (£265m)
Option 2.2: qualitative plus	€60m (£41m)	€150m (£102m)	€390m (£265m)

³¹ Figures in brackets show benefits in pounds sterling using an exchange rate of €1 = £0.68. Figures may not convert exactly due to rounding.

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“loose quantitative limit”			
Option 2.3: qualitative plus 1.7% quantitative limit	€24m (£16m)	€60m (£41m)	€156m (£106m)

5. BENEFITS AND COSTS

5.1 Sectors and groups affected

5.1.1 As an amendment to the EU ETS, the Linking Directive will affect a similar range of sectors and groups to those outlined below, discussed in the context of the EU ETS.

5.1.2 The EU ETS is a mandatory scheme and operators of installations covered by the Scheme must hold a greenhouse gas permit³². It has a direct impact on a number of industrial and other commercial sectors. Over 12 000 installations are covered by the Scheme throughout the EU, accounting for around 45% of total EU emissions. In the UK, the Scheme covers around 1100 installations.

5.1.3 The ETS Directive expressly includes activities carried out at installations in the cement, lime, bricks and ceramics, glass, iron and steel, pulp and paper, and power stations. However, installations from any sector may be covered by the EU ETS if their combustion facilities have a capacity greater than 20MW rated thermal input (excluding hazardous or municipal waste installations). In the UK, this means that the Scheme also covers installations in the refineries, offshore, other oil and gas, chemicals, food and drink, services (including hospitals and universities), engineering and vehicles and textiles sectors.

5.1.4 In the long run, most businesses in the EU will be affected by the EU ETS in one way or another as the operators of regulated installations incorporate the cost of emitting CO₂ into the prices of electricity and other products they produce.

5.1.5 Provision for inclusion of additional CO₂ and non-CO₂ abatement options via the CDM and JI may lead to competitive distortions in particular sectors, particularly if a less stringent baseline approach to that applied to EU ETS allocations is applied to the crediting of emissions reductions projects undertaken both inside and outside the EU.

5.2 Benefits

5.2.1 By providing an increased diversity of compliance options, the Linking Directive will lower the compliance costs for UK operators covered by the EU ETS and provide increased flexibility in meeting targets through investment in

³² See Part 2 of the Greenhouse Gas Emissions Trading Scheme Regulations 2005. Permits for the Scheme contain conditions that must be complied with, including monitoring and reporting requirements.

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cheaper emissions reductions within the EU and beyond. It makes sense to make reductions where it is most efficient and cost-effective to do so, especially since the effects of any emissions reductions are felt globally. Linking the EU ETS to the Kyoto project mechanisms will contribute to an increase in cost-effectiveness of achieving reductions of global greenhouse gas emissions.

5.2.2 Under a no-linking scenario countries would still be able to buy and sell ERUs and CERs on the international market for compliance with their national targets, but business would not be able to use ERUs and CERs for compliance with their targets under the EU ETS. With linking, companies get a great deal more flexibility in how they manage their emissions accounting. By providing operators in the EU ETS with greater opportunity to meet their commitments in the cheapest manner, we would be reducing the competitive risks that they may face from competitors in countries that do not have any climate change commitments.

5.2.3 Linking of the EU ETS with the Kyoto project mechanisms can be expected to improve the liquidity of the Community market in greenhouse gas emissions allowances. It could also lower the market price of allowances if, as forward prices indicate, CERs are cheaper than EUAs in the first phase.

5.2.4 By stimulating demand for ERUs from JI projects, EU companies will further invest in the development and transfer of advanced environmentally sound technologies and knowledge.

5.2.5 The proposal will expand the number of projects that could benefit from the market for carbon. Currently only a few sectors are covered by the EU ETS. The new proposal will expand that through the possibility of JI and CDM projects to include other sectors than those covered by the EU ETS, both within and outside the EU.

5.2.6 The demand for CERs from CDM projects will also be stimulated, and thus developing countries hosting CDM projects will be assisted in achieving their sustainable development goals. They will gain access to investment and more advanced technologies, facilitating their engagement in the international climate change process, capacity building and contribution to sustainable development.

5.2.7 Allowing the use of JI and CDM credits in the EU ETS will lessen the expected increase in electricity prices as the introduction of the credits is expected to lead to a fall in the price of EUAs, by increasing the number of allowances available. Both industry and consumers will benefit because there is a smaller increase in electricity prices.

5.2.8 By investing in JI and/or CDM projects, operators will benefit either from selling the resulting credits gained or by using the credits directly in complying with their EU ETS targets.

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5.2.9 The Linking Directive may allow the EU to set more stringent targets as credits become available from outside the EU, resulting in greater reductions of global greenhouse gas emissions.

5.2.10 Use of credits from CDM projects by operators within the EU ETS will facilitate an increase in CO₂ emissions by operators of UK installations, either through direct UK operator use of CDM credits, or indirectly via the availability of allowances within the EU ETS market as a result of use by operators outside the UK. Increased emissions in CO₂ within the EU would be offset by emission reductions over a range of gases outside the EU.

5.3 Costs

5.3.1 The Linking Directive is mandatory to all EU Member States, therefore the “do nothing” option contains risks associated with not fulfilling UK legal obligations in the EU. In particular, the UK would face infraction proceedings from the EU if it did not implement the Directive.

5.3.2 If no limits are set for the use of CERs during Phase I and CERs and ERUs from Phase II onwards in meeting EU ETS targets (apart from the exclusions required by the Directive), there could be a fall in effort to reduce emissions in the UK. However this risk to domestic effort should be reduced since the Directive requires a limit to be set on the use of CERs and ERUs in Phase II and onwards that is consistent with complementarity obligations³³.

5.3.3 Following on from the above, there may be a reduction in the impact of the EU ETS' contribution to domestic CO₂ reductions i.e. emissions in the UK may increase even though these emissions will be offset by reductions over a range of gases elsewhere.

5.3.4 Reducing emissions outside the UK would mean that associated co-benefits are displaced, for example reduction in other pollutants such as particulates, sulphur or nitrogen dioxide emissions. The reverse may also be true though, as some CO₂ abatement techniques may increase emissions of other pollutants such as NO_x.

5.3.5 Providing operators with cheaper abatement alternatives may also lessen the beneficial impacts of the EU ETS in being a driver of technological investment for long-term emissions reductions.

5.3.6 The Directive places no obligations on charities or voluntary organisations so these bodies will not be subject to compliance costs.

³³ Complementarity is defined in the Marrakesh Accords as an obligation to ensure that *'the use of the mechanisms shall be supplemental to domestic action and that domestic action shall thus constitute a significant element of the effort made by each Party...'*. Please see Decision 15 of the Conference of the Parties 7th session (15/CP.7), available at: <http://unfccc.int/resource/docs/cop7/13a02.pdf> - page=2.

6. SMALL FIRMS' IMPACT TEST – consulting small businesses

6.1 The EU ETS will not bear directly on small firms as much as large firms and the proportion of firms within the Scheme with less than 50 employees is relatively small.

6.2 Future entrants to the EU ETS could include smaller companies which might have less capacity to set up projects. However there are likely to be brokers selling ERUs and CERs which would make it much easier for small companies to get access to the credits.

6.3 With regard to Phase II (2008-2012) of the Scheme, the UK is meeting regularly with other member states and the Commission to discuss various issues, including the treatment of small installations. This is relevant to implementation of the Linking Directive as policy options for Phase I could differ from those for Phase II, and the impact of these options on both phases of the Scheme needs to be considered.

6.4 Most businesses within the EU that are not participating in the EU ETS are likely to be indirectly affected by the Scheme as a result of rises in electricity prices as companies factor the cost of carbon into their products. With regard to the Linking Directive, the cost of carbon will be influenced by options taken on imposing limits on CERs.

6.5 In the event of an undersupply of cheaper CDM credits a limit per installation would ration supply between operators, reduce the dominance of large buyers and sellers in the market, and facilitate more general access to these cheaper credits.

7. COMPETITION ASSESSMENT

7.1 The market for allowances is large and includes a large number of players. However, if the lowest cost of abatement opportunities are only available to a small number of operators, it is possible that the supply of allowances to the market could be relatively concentrated, although there is no evidence of this. Allowing the use of CERs in the market potentially provides for a greater diversity of suppliers to the market, if investors in CDM projects are different to investors in abatement within the EU.

7.2 To the extent that the Linking Directive allows access to a lower cost source of allowances, this is beneficial for the competitive position of UK businesses affected by the EU ETS, particularly those exposed to international competition. It is expected that in some situations the cost of allowances will be passed through in product prices but that may not be possible for operators who compete in markets where the price is set internationally. The availability of lower cost compliance options will be beneficial as this will reduce the operating costs of UK firms. Similarly, limiting

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UK operator's use of CERs for compliance purposes may increase costs for some operators.

7.3 Small operators may have greater difficulty accessing CERs than larger investors. The informational and administrative requirements for investing in CDM projects are substantial and it is likely that only large companies have the capacity to be directly involved in such investment. However, as the process for CDM projects becomes established, CERs should become accessible to small operators through the wider allowance market.

QUESTION	ANSWER
In the market(s) affected by the new regulation, does any firm have more than 10% market share?	Yes
In the market(s) affected by the new regulation, does any firm have more than 20% market share?	Yes
In the market(s) affected by the new regulation, do the largest three firms together have more than 50% market share?	Yes
Would the costs of the regulation affect some firms substantially more than others?	No
Is the regulation likely to affect the market structure, changing the number or size of firms?	No
Would the regulation lead to higher set-up costs for new or potential firms that existing firms do not need to meet?	No
Would the regulation lead to higher ongoing costs for new or potential firms that existing firms do not need to meet?	No
Is the market characterised by rapid technological development?	No
Would the regulation restrict the ability of firms to choose the price, quality, range or location of their products?	No

8. ENFORCEMENT, SANCTIONS AND MONITORING

Implementation and compliance costs

8.1 The ETS Regulations set out various fees and charges that operators covered by the EU ETS, and therefore affected by the Linking Directive, need to pay³⁴. For example, in Phase I, an application for a permit under the EU ETS must be accompanied by a fee (£1230 - £5490, depending on the level of emissions at the installation) and changes to permits (such as variation, transfer and surrender) will also incur fees (£240, £240 and £620 respectively). An annual subsistence charge is also levied on operators in order to enable regulators to recover the costs incurred when exercising their functions under the Scheme. Fees also apply when making an application to the new entrant reserve (£1030) and additional fees can apply to the nomination or change of authorised representatives for registry accounts and verification organisations (£50).

8.2 These fees and charges have been developed in accordance with the polluter pays principle and principles of cost-recovery and cost reflectivity (i.e. the charges reflect the cost of regulator effort). For some of the tasks carried out by regulators, the effort required varies in proportion to the scale of emissions from the installation. A tiered approach to subsistence charges and permit application fees has therefore been adopted, whereby the charges are tiered according to the scale of emissions from the installation. This tiered approach is consistent with the cost-reflectivity principle.

Monitoring and reporting

8.3 Installations are required to monitor and report annual emissions of CO₂ in accordance with a monitoring and reporting (M&R) plan approved by the regulator. The costs of monitoring will depend on the scale and complexity of the installation, and the level of accuracy required by the Commission's Monitoring and Reporting Decision (M&R Guidelines) and the installation's M & R Plan.

8.4 Whilst accuracy requirements are generally lower for smaller emitters, the monitoring and reporting costs will still be relatively high per tonne of CO₂ compared to much larger emitters. Further consideration of costs for smaller emitters and how to minimise them is included in Section 5.4.22.

8.5 The M&R Guidelines require installations to use the highest, most accurate monitoring tiers unless it is not technically or economically feasible to do so. Therefore, each year, installations will need to consider how and

³⁴ See Schedule 5 to the Greenhouse Gas Emissions Trading Scheme Regulations 2005. Amendments to the fees and charges in the UK Regulations were consulted on in late 2004; see: <http://www.defra.gov.uk/corporate/consult/eu-ets-charging/index.htm> and: <http://www.defra.gov.uk/corporate/consult/euets-regs2/index.htm>. Partial RIAs providing further analysis of the impact of fees and charges is also available on these web-pages.

whether they can improve the accuracy of their monitoring. Improving accuracy will incur costs, such as installing new gas meters, but will have the added benefit of more accurate reporting of emissions and hence the purchase or sale of allowances.

Annual verification costs

8.6 Operators will also be required to pay for annual verification of their monitoring programme and annual emissions report. Accredited verifiers will check that the monitoring has been carried out in accordance with the M & R Plan and verify that the annual emissions figure is fairly stated and free from material errors. Costs of annual verification will depend upon the scale and complexity of the installation and whether the operators have transparent and accessible data and record management systems. The process for annual verification is required by the EU ETS Directive and will be explained in a Government guidance note currently being developed in consultation with stakeholders.

8.7 Verification bodies pay an application fee to UKAS when they apply to become accredited. These costs are likely to be recovered from operators through charges for verification services.

8.8 The costs of monitoring, regulator fees (subsistence fees, permit variations and application fees), report writing and verifications per tonne of CO₂ will depend on the scale of emissions from the installations. For smaller installations (discharging less than 50,000 tCO₂ per year), analysis suggests that costs may be between €4.00 – €10.50 per tonne of CO₂ emitted per year, while for larger installations (between 50 – 100,000 tCO₂ per year) they may be between €0.90 – €1.35 per tonne of CO₂.

Financial penalties

8.9 Under the EU ETS, financial penalties will be levied on those companies that fail to meet their targets. Member States have discretion to apply penalties for more minor offences (e.g. breaching monitoring and reporting guidelines). The Registries Regulation enforces the rules on conversion of project credits to EU ETS allowances³⁵.

8.10 In Phase I, failure to surrender the correct number of allowances will result in a penalty of €40 per tonne during Phase I (2005-7) of the Scheme. In Phase II, this cost will increase to €100 for each tonne of CO₂ for which no allowance is surrendered. Payment of the penalty does not remove the operator from the obligation to surrender allowances to cover those emissions.

³⁵ See http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2004/l_386/l_38620041229en00010077.pdf.

9. POST-IMPLEMENTATION REVIEW

9.1 This full RIA amends and updates the partial RIA which accompanied the second consultation on the Linking Directive, which closed on 19 August 2005³⁶. The first consultation³⁷ covered UK priorities in negotiation of the Directive.

9.2 The potential for compensatory simplification has been considered as part of the transposition process. As the Linking Directive is essentially providing UK operators covered by the EU ETS with additional options for cheaper compliance with their obligations, it is considered that this is an enabling rather than a constraining piece of legislation and that it is therefore less necessary to compensate through the removal of other regulatory measures. However, the UK is actively working with other Member States and the Commission to examine whether there are any legislative or administrative options to reduce the burden on small installations and low emitters currently covered by the Scheme. This has emerged as one of the key issues resulting from the implementation of Phase I, and concerns have been raised as to whether it is appropriate for such installations to be included in the EU ETS when the financial and administrative burden are high in relation to their actual emissions.

9.3 These small installations include around 165 public sector installations such as universities, hospitals and defence installations, whose emissions are typically below around 50 000tCO₂/yr. This is part of ongoing efforts to ensure that the level of administrative effort required by operators is proportional to their level of emissions, and that the coverage of the scheme is not unreasonably wide. Work on regulatory simplification for these operators includes reducing administrative (i.e. permitting, monitoring and reporting) charges for smaller emitters in Phase II of the scheme (2008-2012)³⁸.

9.4 Government is currently amending the Greenhouse Gas Emissions Trading Regulations 2005 to enable a proportion of free allowances to be issued to existing installations that did not obtain Greenhouse Gas Permits and were therefore not granted free allowances from National Allocation Plan. Late entrants are likely to be smaller manufacturing businesses, hospitals and possibly universities that did not know about the Scheme or that made incorrect calculations about whether they were included. Without these regulations, late applicants would be required to purchase all the allowances they need to cover their annual carbon dioxide emissions and this could be potentially very costly for operators depending on how much carbon dioxide they emit

9.5 Although these installations will not receive the full allocation that they would have received had they been in the NAP, they will receive a substantial proportion (90% for applications received by 31 August 2005, and 75% for

³⁶ See <http://www.defra.gov.uk/corporate/consult/euets-linkingdir/index.htm>

³⁷ See <http://www.defra.gov.uk/corporate/consult/euets-link/index.htm>.

³⁸ Charges are already staggered for Phase I, but we are considering taking this further.

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applications received between 1 September 2005 and 28 February 2007). Once the set aside of 1.5Mt of allowances runs out any subsequent late applicants will need to purchase all their allowances. While this amendment involves additional legislation rather than less regulation, it does aim to reduce the administrative burden of the EU ETS on smaller businesses. Further information about the late entrant set aside can be obtained from the Defra website³⁹.

9.6 Government has recently consulted on its approach in the development of the Phase II National Allocation Plan⁴⁰, due to be submitted to the European Commission by June 2006. This process involves a review of the Phase I policies, and RIAs will be published at key intervals and will include analyses of options relating to the Linking Directive.

10. SUMMARY AND RECOMMENDATIONS

10.1 Access to the flexible mechanisms will reduce operators' costs of compliance with their commitments under the EU ETS. It will also reduce the indirect impact of the EU ETS on other parts of the economy.

10.2 Reducing the costs of compliance must be balanced with the environmental integrity of the EU ETS. The Directive contains safeguards to ensure the environmental integrity while reducing the costs for operators.

10.3 Significant domestic action must be ensured. We are committed to this under the UNFCCC, and the Commission's proposal contains sufficient safeguards for this. We are bound to transpose this Directive into UK law by 13 November 2005.

10.4 Following analysis of consultation responses, there will be no limit placed on the use of project credits in Phase I of the EU ETS. This will provide operators with as much flexibility as possible in meeting their compliance obligations and is in accordance with Option 2, as discussed above in paragraphs 4.1.10-4.1.15

³⁹ Please see: <http://www.defra.gov.uk/environment/climatechange/trading/eu/permits/index.htm> - late

⁴⁰ See <http://www.defra.gov.uk/corporate/consult/euets-phasetwo/index.htm>

11. DECLARATION

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed: *Elliot Morley*

Date: *16th October 2005*

ELLIOT MORLEY, MINISTER OF STATE

DEPARTMENT FOR ENVIRONMENT FOOD AND RURAL AFFAIRS