

C/M/S/ Cameron McKenna

Phase III of the EU Emissions Trading Scheme: your Q&A guide

Part of the 2020 climate package series



“The firm has been increasingly involved in emissions trading, an area in which it is considered to be at the vanguard”.

Chambers & Partners Global

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Introduction

Climate change is now inescapably one of the most important policy issues at the national, EU and international level. At the core of the climate change debate lies the question of how the world's most industrialised countries can externalise the cost of climate change and allocate that cost onto greenhouse gas emitters, causing them to significantly reduce their greenhouse gas emissions without seriously impacting on their international competitiveness.

It has been almost five years since the European Union's Emissions Trading Scheme (EU ETS) was introduced, and it has since developed into the world's largest cap and trade emission allowance programme. The Kyoto Protocol commitment to reduce its emissions by 8% compared to 1990 levels in the 2008-2012 period remains a primary driver, with the EU ETS being one of the EU's key tools for sending the right price signals to carbon-intensive industries.

With Phase II of the EU ETS due to end in 2012, calls for a more ambitious climate change and emission reduction policy for Phase III have been growing, and the EU has recently adopted a new series of Directives as part of its "2020 climate change package" to rise to the challenge of more ambitious carbon reduction targets. The overall aim of the package is to enable the EU to reduce its emissions of greenhouse gases by 20% in 2020 compared to 1990 levels, as well as to increase the share of energy from renewable sources consumed in the EU to 20% of the EU's gross consumption of energy by that same date.

Phase III of the EU ETS will run from 1 January 2013 to 31 December 2020. As part of the 2020 climate change package, a new Directive will reform the structure of the EU ETS for Phase III by:

- imposing more challenging emission reduction targets on installations subject to the EU ETS
- gradually phasing-out the free allocation of allowances that took place in Phases I and II and replacing that with a system of allowance allocations through auctions
- broadening the scheme to more industrial sectors and greenhouse gases.

In a separate but related development, the aviation industry, which is not currently affected by the EU ETS, will be included in the EU ETS from 1 January 2012 following the adoption of the Aviation Directive 2008/101/ EC. The aviation sector will therefore have to adjust quickly to the requirements of the EU ETS.

This briefing note, which is part of CMS Cameron McKenna's 2020 Climate Package Series, highlights the essential details of the EU ETS regime, including:

- a short overview of the mechanisms of the current EU ETS
- an introduction to the main changes that will be implemented in Phase III and how they may affect your business
- an overview of the key impacts of the EU ETS for the aviation sector.

If you would like more specific information on how the EU ETS and the Phase III changes will affect your business, please contact us.



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How does the EU ETS currently work?

Which sectors and greenhouse gases does the EU ETS currently cover?

Currently, the EU ETS only covers activities resulting in emissions of carbon dioxide from nearly 12,000 participating installations (with the exception of The Netherlands, which has opted in emissions from nitrous oxide). Compliance with the EU ETS is mandatory for industrial installations in the power generation, oil refinery, steel, cement and lime, pulp, board and paper sectors if they exceed certain thresholds.

An installation is defined in the EU ETS Directive as a “stationary technical unit” carrying out a *specified activity* and “any directly associated activities which have a technical connection with the activities carried out on that site and which could have an effect on emissions and pollution.”

How does emission trading work?

The aim of the EU ETS is to provide a cost efficient way of reducing emissions by using a market-based ‘cap and trade’ system. This system is founded on the rationale that emission reductions should take place where the cost of reduction is the lowest, thus lowering the overall cost of combating climate change.

The total amount of emissions allowed from all installations subject to the EU ETS is capped at a maximum limit converted into allowances. One allowance equals one tonne of carbon dioxide. The companies operating these installations (referred to under the EU ETS as “operators”) are required to obtain greenhouse gas emissions permits (i.e. authorisations to emit carbon dioxide) in their country of operation, failing which they can be subject to financial penalties. All permitted installations then receive a free annual allocation of allowances (equal to each installation’s emissions cap for a year) by 28 February of each year.

Operators of installations can develop their own compliance strategy aimed at meeting the overall reduction requirements. For example, an installation that emits in excess of its allocated allowances can purchase additional allowances from the market, whereas an installation that emits less than its allocation can sell the surplus allowances.

How are allowances allocated and traded?

Member States were required to produce national allocation plans for Phases I and II, setting out the total quantity of allowances that they intended to allocate to all participating installations based on objective and transparent criteria. The majority of allowances is currently allocated free of charge, but Member States were permitted to auction up to 5% of allowances in Phase I and up to 10% of allowances in Phase II. All national allocation plans for Phases I and II had to be approved by the Commission before the beginning of each phase.

The legal framework of the EU ETS provides for trading of the allowances on the carbon market. Each Member State is required to maintain an electronic registry that keeps records of the issue, holding, transfer and cancellation of allowances. The allowances only exist in an online registry account in electronic format. All participating installations and any interested parties may open a trading account anywhere in an EC registry. Each Member State is under an obligation to ensure the accurate accounting of allowances under the scheme.

In addition, all Member State registries have a link to the Community Independent Transaction Log (CITL) that acts as a central administrator and operates as an EU wide registry that keeps an account of any activity taking place in individual Member State registries.

What are the main obligations imposed on operators?

Operators of installations are required to monitor and report emissions on an annual basis. Each operator is required to submit a report to the relevant regulator in its Member State at the end of each calendar year. The report will contain emissions data for the previous calendar year that has to be verified by an independent verifier based on the verification principles outlined in the Directive.

The operator of each installation must then surrender a number of allowances equal to the total verified emissions from that installation during the preceding calendar year by no later than 30 April or be subject to financial penalties. Member States are also subject to reporting obligations and have to submit a report to the Commission evidencing compliance with the EU ETS Directive on an annual basis.

It should be noted that the aviation sector, which will be subject to the EU ETS from 1 January 2012 onwards, will be subject to the same general monitoring and reporting obligations as other sectors with some additional sanctions applicable in case of non-compliance. More information on this is available in the aviation section below.

Overview of key obligations



Defra, *An Operator's Guide to the EU Emissions Trading System: the steps to compliance* (May 2008)

Does the EU ETS allow for use of emission reduction credits generated outside the EU?

Yes. In July 2003, the EU adopted Directive 2004/101/EC (The Linking Directive) that linked the EU ETS with project mechanisms under the Kyoto Protocol. The Linking Directive allows installations participating in the EU ETS to use a specified proportion of emission reduction credits generated by the Kyoto Protocol's emission reduction projects (the so-called Joint Implementation (JI) and Clean Development Mechanism (CDM)) in order to fulfil their surrendering obligations under the EU ETS.

What will be the main changes in Phase III (2013-2020)?

The Commission recently adopted a new directive amending the current EU ETS for Phase III, which is due to begin on 1 January 2013. The amended directive, which was adopted by the Council on 6 April 2009, has brought a number of changes to the current system.

How will the cap on emissions be determined?

The EU ETS in Phase III will be subject to a more stringent emissions cap. The Commission proposed a 20% reduction in greenhouse gas emissions below 1990 levels by 2020 and a 50% reduction below 1990 levels by 2050. Unlike Phases I and II, where discretion to determine the emissions cap was left to individual Member States, the cap will be set at an EU-wide level in Phase III.

Which sectors and greenhouse gases will be covered?

The scope of the EU ETS will be extended to include new sectors and new gases covering:

- carbon dioxide emissions arising from petrochemicals, ammonia, and aluminium sectors;
- nitrous oxide emissions from the production of nitric, adipic and glyoxylic acid, and perfluorocarbons emissions from the aluminium sector; and
- capture, transport and geological storage of carbon dioxide emissions.

Sectors and greenhouse gases covered by the EU ETS

Sector	Phase I - II	Phase III
Power generation	Carbon dioxide	Carbon dioxide
Oil refinery	Carbon dioxide	Carbon dioxide
Steel	Carbon dioxide	Carbon dioxide
Cement and lime	Carbon dioxide	Carbon dioxide
Pulp, board and paper	Carbon dioxide	Carbon dioxide
Petrochemicals, ammonia and aluminum	-	Carbon dioxide
Production of nitric, adipic and glyoxylic acid	-	Nitrous Oxide
Production of perfluorocarbons	-	Nitrous Oxide

How will the cap on allowances be calculated?

The objective of Phase III is to achieve a **20%** reduction in greenhouse gases by **2020** compared to **1990** levels. The EU-wide cap on allowances will be determined by using the average total quantity of allowances issued by Member States in Phase II as a starting point, and then applying a linear emission reduction factor of **1.74%** for each subsequent year. The exact quantity of allowances available for 2013 will be published by 30 June 2010 and the annual emissions caps will be published by 30 September 2010.

How will allowances be allocated?

Auctioning is set to become the basic method of allocating allowances from 2013 onwards. This means that all allowances not allocated free of charge will be auctioned by Member States. Member States will administer the auctions and will be responsible for the development of auctioning infrastructure. The Commission will adopt a regulation governing various aspects of the auctioning process by 30 June 2010 and plans to publish the estimated number of allowances to be auctioned by 31 December 2010.

The allocation of allowances to individual sectors will be based on 'benchmarks' taking into account the number of allowances per historic output and not historic emissions. This principle of allocation aims to reward operators that have reduced their emissions using most energy efficient technologies.

How many allowances will Member States auction?

Once the Commission determines the total quantity of allowances to be allocated in Phase III, the amount of allowances to be auctioned by each Member State will be determined as follows:

- 88% of allowances will be distributed between Member States according to their verified emissions in 2005 or the average for the period of 2005-2007 (whichever is higher)
- 10% of allowances will be distributed to Member States with low income per capita to encourage investment in climate friendly technologies
- 2% will be distributed among Member States, which, in 2005, achieved emission reductions of 20% below the levels set for the base year under the Kyoto Protocol.

How will allowances be allocated to the power sector?

The power sector will be subject to full auctioning from 2013 onwards, meaning that electricity generators will need to purchase all their allowances up to their emissions cap for a particular year through auctioning. However, electricity generators may receive free allowances for district heating and high-efficiency cogeneration activities in respect of heating and cooling.

Are there any exemptions?

Yes. New EU Member States may temporarily derogate from the full auctioning rule applicable to the power sector and receive a proportion of their allowances free of charge if:

- in 2007, the electricity network of a particular Member State was not interconnected with the EU system; or

- in 2007, the electricity network was connected to the EU system through a single line with a capacity of less than 400MW; or
- in 2006, more than 30% of electricity of a particular Member State was produced from a single fossil fuel and the GDP per capita in relation to the EU average did not exceed 50% of the average GDP per capita of the EU.

The auctioning rate for Member States benefiting from this derogation will be set at a minimum of **30%** of an installation's emissions' cap in **2013**, increasing to **100%** in **2020**.

This derogation will apply to activities related to the modernisation of the electricity sector. In order to qualify, Member States will be required to submit to the Commission national plans outlining their modernisation investment strategy as well as reports on the implementation of these strategies. In addition, Member States will have to submit a report to the Commission by 30 September 2011 detailing the allocation methodology and individual allocations to installations. The total amount of the intended investment in the electricity sector will be equal to the market value of the allowances received free of charge.

How will allowances be allocated to other industrial sectors?

Other industrial sectors will benefit from a gradual transition towards full auctioning of allowances. Subject to sectors not being at risk of carbon leakage (see below), these sectors will need to purchase **20%** of their allowances through auctions in **2013**, this proportion increasing to **70%** in **2020** and **100%** in **2027**.

Are there any exemptions?

Yes. In Phase III, energy intensive sectors and sub-sectors at risk of carbon leakage will be exempt from the auctioning requirement and may receive up to 100% of their allowances free of charge. Sectors at risk of carbon leakage are essentially sectors that may suffer a material competitive disadvantage against competitors located in areas outside the EU, which do not have similar emission reduction commitments.

How will the sectors at risk of carbon leakage be identified?

The Commission proposed criteria for the assessment of exposure of certain sectors to carbon leakage and will identify the sectors that can benefit from a free allocation of allowances by 31 December 2009. The list of sectors at risk will be reviewed every 5 years. The Commission may propose additional measures and review the proportion of allowances allocated free of charge by 30 June 2010, particularly in light of the emission reduction commitments taken on by other countries outside the EU in the successor treaty to the Kyoto Protocol expected to be signed in Copenhagen in December 2009.

Member States may also adopt financial measures to compensate the sectors at risk of carbon leakage arising out of the pass through of CO₂ costs in electricity prices. The Commission has undertaken to modify the rules applicable to state aid accordingly.

Auctioning rates per sector: Phase III and beyond

Sector	2013	2020	2027
Power generation	100%	100%	
Power generation in new Member States	30%	100%	
Other	20%	70%	100%
Sectors at risk of carbon leakage	Up to 100% may be allocated free of charge		

What provision will be made for new entrants into the EU ETS?

New entrants joining the EU ETS in 2013 will be able to benefit from free allocation of allowances from the new entrants reserve (with the exception of new entrants involved in power generation activities). The amended EU ETS Directive defines '*new entrants*' as:

- installations that will receive their greenhouse gases emissions permits for the first time after 30 June 2011; or
- installations that decide to include new activities and greenhouse gases approved by the Commission into the scope of the EU ETS; or
- installations undergoing '**significant extensions**' after 30 June 2011. The extension is significant if it extends the installation's existing capacity by at least 10% or where a substantial increase of the emissions is linked to the increase of the installation's capacity.

It should be noted that the Commission plans to review the definition of new entrants and its application to significant extensions by 31 December 2010.

The new entrants reserve will contain 5% of the EU wide quantity of allowances. Any allowances left in the reserve at the end of Phase III will be auctioned by Member States.

How many allowances will be allocated to carbon capture and storage demonstration projects?

Approximately 300 million allowances in the new entrants reserve will be available until 31 December 2015 to help stimulate the construction and operation of up to 12 demonstration projects for the environmentally safe capture, transport and geological storage of carbon dioxide, as well as demonstration projects of innovative renewable energy technologies. As an incentive, there will be no need to surrender allowances for captured and stored emissions and Member States will transfer the market value of the allocated allowances to the operators of such projects.

What are the selection criteria for carbon capture and storage demonstration projects?

The CCS projects eligible for free allocation will have to meet the following criteria:

- a single project will not be able to receive free allowances in excess of 15% of the total number of available allowances
- projects will be created in geographically balanced locations across the EU representing a wide range of technologies
- a Member State may choose to co-finance the projects that will be selected on the basis of objective and transparent criteria.

Are there any exemptions from participation in the EU ETS?

Yes. Currently, a large number of small installations emitting low amounts of carbon dioxide are subject to the EU ETS. A 'small' installation is an installation that:

- emits 25,000 tonnes of carbon dioxide equivalent per year; or
- has a rated thermal input below 35MW for combustion activities.

From 2013 onwards, Member States will be allowed to exclude small installations from the EU ETS, provided such installations apply equivalent measures for reducing emissions and have appropriate monitoring, verification and reporting measures in place. Installations operated by hospitals will also be excluded from the EU ETS but only if they achieve equivalent emission reductions.

In addition, Member States may allow simplified monitoring, verification and reporting measures for installations with annual verified emissions less than 5,000 tons a year during the period 2008-2010.

Will operators still be entitled to use credits from CDM and JI projects?

Yes, the revised EU ETS Directive will extend the right to use credits arising from projects undertaken in third countries under the Kyoto Protocol. As in Phases I and II, these projects must be officially recognised under the Kyoto Protocol's project mechanisms. Only unused credits from projects eligible for use in the EU ETS during 2008-2012 will be accepted to meet surrendering obligations in Phase III.

The regulator in each Member State can make the exchange on request by 31 March 2015. The overall use of credits is capped at 50% of the EU wide emission reductions over the period 2008-2020 and 50% of the EU wide reductions below the 2005 levels of new sectors and aviation for the period 2013-2020.

Existing operators will be able to use credits up to a minimum of 11% of their total allocation in 2008-2012, while operators with the lowest sum of free allocation in 2008-2012 can exceed the 11% limit. For existing installations this will represent a total level of access of approximately 1.6 billion credits over the period of 2008-2020.

New entrants will benefit from a higher threshold and will be able to use a guaranteed amount of credits of 4.5% of their verified emissions during 2013-2020. The aviation sector will be able to benefit from a lower threshold of 1.5% of total verified emissions in 2013-2020.

Note that if and once an international agreement to succeed to the Kyoto Protocol has been reached, only credits from projects in third countries that have ratified the agreement or from additional types of projects approved by the Commission will be eligible for use in Phase III.

Will the monitoring, reporting and verification requirements be amended?

Yes, the Commission intends to adopt a new regulation by 31 December 2011 setting out monitoring and reporting requirements for Phase III. A separate regulation will govern verification of emissions and the accreditation of independent verifiers.

What are the key next steps?

At **EU level**, the EU Commission is still required to prepare the following legal instruments in order to give full effect to the proposed directive:

- a regulation providing detail on the timing, administration and other aspects of auctioning (due by **June 2010**)
- a regulation on harmonised allocation rules (due **end 2010**) for allocation of allowances other than by auctioning
- two regulations setting out the details of the new monitoring, reporting and emission verification regime (due at the **end of 2011**).

At **Member State level**, Member States will be required by the proposed directive and Article 288 of the EC Treaty to put in place national legislation implementing the aims set out in the proposed directive by 31 December 2012. In the UK, this is likely to take the form of a regulation either amending the existing Greenhouse Gas Emission Trading Scheme Regulations 2005 or replacing them in their entirety.

Key next steps



Inclusion of Aviation Sector into the EU ETS: what are the key impacts?

What flights will be covered by the EU ETS?

On 1 January 2012, the aviation sector will join the EU ETS. The EU ETS will cover all flights arriving at or departing from any EU airport from 2012 onwards and will apply to carbon dioxide emissions only. The first year of participation will serve as an introductory phase in preparation for Phase III.

Who will oversee the implementation of the Aviation Directive?

An administering Member State will be responsible for monitoring compliance of a particular aircraft operator with its obligations under the EU ETS.

For EU aircraft operators, the administering Member State is the state that granted the operating licence to the particular aircraft operator.

For non-EU aircraft operators, the administering Member State is normally the state to which the aircraft operator contributed the highest level of its emissions in 2006 (or if an airline started operating in the EU after 1 January 2006, the first year of operation in the EU). The Commission published a preliminary list of aircraft operators and their administering Member States on 11 February 2009.

What will the emissions cap for 2012 and Phase III be?

The aviation sector will be subject to the revised rules proposed for Phase III. The emissions cap will be set at the EU wide level by reference to a baseline of the average emissions from the aviation sector in 2004-2006, as follows:

- **2012:** the emissions will be capped at **97%** of the average;
- **2013-2020:** the emissions will be capped at **95%** of the average.

The Commission plans to conduct a review of historical aviation emissions in order to determine the average level of emissions and will publish its findings by 2 August 2009.

How will allowances be allocated to the aviation sector?

The aviation sector will be subject to the same general principles of allocation as other sectors and installations participating in the EU ETS. The emissions cap set for the aviation sector will be converted into allowances. One allowance will equal one tonne of carbon dioxide.

The majority of allowances will be issued to aircraft operators free of charge in the following manner:

- In **2012:** **85%** of allowances will be issued **free of charge** and **15%** will be **auctioned**
- In **2013-2020:** the percentage of allowances that will be auctioned may be increased as part of the general review of the Aviation Directive that the Commission plans to undertake ahead of Phase III.

The requirements governing the auctioning process in Phase III will apply to the aviation sector. Please refer to the section "How will allowances be allocated" for more information.

How can aircraft operators obtain free allowances?

Aircraft operators will have the option to apply for allocation of free allowances by submitting an application to the relevant regulator in the administering Member State. The application will have to be submitted no later than **31 March 2011** for the period beginning on 1 January 2012.

The Commission will decide on the number of allowances that will be auctioned and distributed free of charge and will publish criteria for allocation of allowances to individual operators by 30 September 2011.

What are the next steps?

Aircraft operators will be required to monitor fuel consumption and emissions from **1 January 2010** onwards. The verified emissions data collected during 2010 will have to be submitted together with the application for free allowances. This is because the total number of free allowances will be based on the 'benchmark' factor that takes into account the total emissions per tonne kilometer of an aircraft operator in 2010.

What provision will be made for new and growing airlines?

From 1 January 2013, airline operators will be able to benefit from a special reserve fund. The fund will contain a total of 3% of the total quantity of allowances allocated to the aviation sector for Phase III. The airlines can benefit from the special reserve fund if they are:

- new entrants that started operations after 2010; or
- growing airlines with an increase in tonne-kilometre data of more than 18% per annum.

Airline operators can submit an application for free allocation of allowances to the relevant regulator no later than 30 June 2016. It should be noted that allocation from the fund to "growing" airlines will be limited to 1,000,000 allowances.

Which airlines are exempt from participation in the EU ETS?

If a commercial aircraft operator performs less than 243 flights per year or performs flights with total annual emissions lower than 10,000 tonnes per year, it will be exempt from participation in the EU ETS.

The exemption also covers flights on official mission, military flights, search and rescue, flights performed under visual flight rules as defined in Chicago Convention, training flights, scientific research, flights with a certified maximum take-off mass of less than 5 700 kg, and flights performed as a part of public service obligations.

Will credits from CDM and JI projects be available to airline operators?

Yes, aircraft operators will be able to use credits generated by emission reduction projects under the Kyoto Protocol mechanisms up to a specified limit of the total amount of allowances they are required to surrender in respect of each calendar year.

In 2012, aircraft operators will be able to use credits from CDM or JI projects up to 15% of the total number of allowances that they are required to surrender for that year. For subsequent years in Phase III, the Commission shall review the percentage of credits from CDM and JI projects which may be used by airline operators as part of the Commission's review of the Aviation Directive. However, you should note that the new EU ETS Directive for Phase III states that airline operators should be able to use an amount of credits from CDM and JI projects equal to at least 1.5% of their verified emissions in the 2013-2020 period.

Will the aviation sector be subject to different monitoring, reporting and verification requirements?

No, the aviation sector will have to comply with the same general reporting, monitoring and verification requirements and will be subject to the same financial penalties in case of non-compliance applicable to other sectors in Phase III. However, in addition to these requirements, the aviation sector will be subject to strict penalties in case of non-compliance.

In particular, in addition for being liable to pay excess emissions penalty when surrendering an insufficient number of allowances, an airline operator could also be subject to an operating ban if it fails to comply with the requirements of the EU ETS. The ban would only be imposed following a consultation procedure by the Commission with relevant regulators and Member States.

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