

EN

EN

EN



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.11.2006
COM(2006)676 final

**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE
EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE AND THE COMMITTEE OF THE REGIONS**

**Building a global carbon market –
Report pursuant to Article 30 of Directive 2003/87/EC**

1. INTRODUCTION

Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC¹ (hereinafter referred to as "the Directive") entered into force on 25 October 2003. On 1 January 2005, the EU Emissions Trading Scheme (the "EU ETS") became reality. The purpose of the scheme is to promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner. The Commission fully endorses the Council's view² that the EU ETS is an essential instrument for achieving the medium- and long-term emission reductions that are necessary to stabilise greenhouse gas concentrations in the atmosphere.

The EU is committed to a global carbon market as a key instrument for tackling climate change. The EU emissions trading scheme is already a key driver of international carbon trading and provides a solid foundation for a global carbon market. Currently, over 160 countries, representing over 90% of the global population, can engage in the emerging carbon market either through emissions trading schemes or through the Kyoto Protocol's project-based mechanisms. A number of countries are interested in introducing similar emissions trading schemes and the EU ETS is engaging developing countries in concrete actions to reduce greenhouse gas emissions through the Clean Development Mechanism. This demonstrates the strategic importance of the EU ETS.

In September 2005, the Commission announced its intention to propose the extension of the scheme to include climate change impacts from the aviation sector³. Article 30 of the Directive provides for the Commission to draw up a report to the European Parliament and the Council by 30 June 2006 on the application of the Directive, accompanied by proposals as appropriate. The Commission has considered the issues listed in Article 30 as well as further issues highlighted by stakeholders, taking some additional time to do so. While there is growing consensus on the key strategic issues for review, more experience and evaluation is needed for addressing these issues. It would therefore be premature for the Commission to make legislative proposals at this stage. In addition, the Commission takes the firm view that for reasons of regulatory stability and predictability, any changes to the Directive emanating from this review should take effect at the start of the third trading period in 2013. Therefore, in order to ensure broader involvement of stakeholders with a high quality input into the review process, the Commission intends to consult further by means of a separate Working Group on the Review of the EU ETS within the framework of the European Climate Change Programme (ECCP)⁴, which contributed to the development of the EU ETS and other climate measures. The working group will start work this autumn and its report will feed into a legislative proposal by the Commission in 2007. The further review process in the ECCP group will focus on the strategic

¹ OJ L 275, 25.10.2003, p. 32.

² Council Conclusions of 17 October 2005, doc.1345/05.

³ COM (2005)459 final.

⁴ For more information on the ECCP I and II, please see: <http://ec.europa.eu/environment/climat/eccpii.htm>

issues set out in the Annex to this report. This Communication does not deal with the level of ambition for the post-2012 period that will be the subject of a separate communication.

As the review proceeds, it will also take into account developments in the international negotiations for addressing climate change beyond 2012. The wider international context and activities other than emissions trading will be specifically addressed by the Commission's forthcoming Green Paper on costs and benefits for post-2012 climate policy.

2. THE EU ETS AFTER THE FIRST COMPLIANCE CYCLE

The data from the first compliance cycle show that by the compliance deadline of 30 April 2006, some 8,980 installations had fulfilled their obligations with regard to reporting 2005 emissions. These installations account for more than 99% of allowances allocated to installations in the 21 Member States with functioning electronic registries on 30 April 2006.

The independently verified data showed lower greenhouse gas emissions than had been expected. To the extent that it reflects companies having reduced emissions already in the first year of the EU ETS, this is a positive development⁵. However, to the extent that it reflects an over-estimate of baseline emissions, it means that the environmental outcome of the scheme in the first period will not be as large as it could have been, nor as large as will be necessary to adequately address climate change. This is not unprecedented for the initial phase of an emissions trading scheme: there have been similar experiences in the US e.g. when the sulphur dioxide scheme started.

Member States were required to submit national allocation plans for the 2008 to 2012 period to the Commission by 30 June 2006, and the first compliance cycle results provide a solid and transparent basis for these plans. In order to be consistent with the Directive and Articles 87 and 88 of the EC Treaty, the stringency of these national allocation plans for the 2008 to 2012 period has to be determined based on the aggregate 2005 verified emissions data, Member States achieving their Kyoto Protocol commitments and other allocation criteria.

All national allocation plans for the first trading period have now been finalised and registries are active in all Member States. Throughout this first phase valuable lessons have been learnt by authorities and participating companies alike that will enable us to be better prepared for the trading period 2008 to 2012 and that also form useful input for the review process.

The functioning of the allowance market and links to product markets

The EU ETS allowance market already developed ahead of the start of the scheme with the first forward transactions having been contracted in 2003. In 2005, more

⁵ Factors such as weather conditions can also affect emissions.

than 320 million allowances worth more than €6.5 billion⁶ were reported as having been traded over-the-counter, at exchanges or bilaterally. As regards 2006, by May a trading volume of over 300 million allowances had been reported and the monthly trading volume in May had approached 100 million allowances⁷. Transactions under the EU ETS dominate the global carbon market, accounting for over 80% of the monetary value and over 60% of the total volume of carbon trades⁸.

According to responses in a survey⁹, power companies and refineries were among the most active in the market initially, while steel and aluminium companies had not traded at all by mid-2005. The reason for this is most likely that many power generators and refineries have access within their company structure to extensive experience of trading in related commodity markets. Once the first exchanges emerged around mid-2005, banks and investment funds started to offer services to inactive companies to trade allowances on their behalf⁷.

Analysts cite various factors influencing the allowance price over time: reduction potential and costs to reduce emissions, allocations, reported actual emissions, access to and availability of JI and CDM credits, fossil fuel prices, weather patterns (temperature, precipitation) and degree of participation across different sectors in the market. The allowance price has so far reacted also to political developments.

The most significant short term allowance price development so far took place in connection with the release of 2005 verified emissions data in May 2006. Both the timing of the release (unannounced pre-release by several Member States) and the actual level of the 2005 emissions data (lower in aggregate than expected by many market observers) caused a substantial decline in the market price within a few days. Several stakeholders have thus voiced concerns about the degree of volatility experienced so far. In this context it must be stressed that new markets need time to establish sufficient and reliable information sources and therefore tune its reaction to the fundamental price drivers. A higher degree of volatility has been observed in the initial phase of other successful environmental markets. Thereafter, volatility decreases, facilitated by stable political signals, legislative stability, and strong compliance enforcement.

As expected, the allowance market affects the product markets in which operators are active. It is inherent to a successful market-based instrument that the carbon price signal flows through the economic chain gradually inducing moves to low-carbon production and consumption choices at each stage. The degree of integration of the carbon price signal in product markets has been mixed so far. In some sectors the degree of outside competition from competitors not being subject to similar climate change policies has limited pass through of the value of allowances. In other sectors, notably power generation, pass through potential has been more important, and has contributed to an increase in electricity prices,

⁶ State and Trends of the Carbon Market 2006, The World Bank and IETA, available at <http://carbonfinance.org/docs/StateoftheCarbonMarket2006.pdf>

⁷ Point Carbon

⁸ Point Carbon "Outlook for 2006: Mid-year update". *Carbon Market Analyst*. 3 August 2006. Oslo.

⁹ See results of McKinsey/Ecofys web survey carried out for the European Commission at http://ec.europa.eu/environment/climat/emission/review_EN.htm.

although the main reasons for this price hike are rising energy prices on the world market and structural aspects of the European energy market.

The past 18 months have seen large changes in the energy market, not least a significant rise of oil prices. This had an important upward effect on prices for natural gas, resulting in increased use of coal for generating power, driving demand for allowances and low-carbon options, and demonstrating the increasing integration of power, fuel and allowance markets.

While the volume of allowances traded has grown steadily since the start of the scheme and the market is gradually maturing, the Commission shares the view expressed by many stakeholders that increased certainty and predictability about the ambition levels and allocation methodologies are important requirements for improved market liquidity. In this way, market fundamentals should drive the allowance price in the medium term as a stable political and legislative framework enables the sustainable environmental and economic success of the instrument.

3. THE REVIEW PROCESS

3.1 The need for more experience and stakeholder consultation

The first 18 months of the EU ETS have proven to be a very valuable learning period, showing that the simplicity and predictability of the scheme should be enhanced¹⁰. The Directive provides that key implementation decisions for the trading period 2008 to 2012 are to be taken by Member States in the course of 2006, namely submission of national allocation plans and adoption of final national allocation decisions. In order to preserve a stable regulatory framework for the rapidly developing allowance market over the course of the second trading period, and to allow sufficient lead-time for any adjustments that may arise out of a legislative process, the Commission is convinced that any adaptations to the design of the EU ETS arising from this review should take effect at the start of the third trading period in 2013³. At the same time the quality of the review process will benefit from more experience with the elements of the scheme as they are currently applied, and the Commission realises the importance of further stakeholder consultation and analysis ahead of the launch of a legislative process.

A number of reports and position papers have been developed, which serve to inform the review of the EU ETS. The Commission welcomes the support by the High Level Group on Competitiveness, Energy and the Environment, which confirms its preference for a well functioning EU ETS as a central instrument for

¹⁰The need for simplicity is emphasised in the Commission's Communication on further guidance on allocation plans for the 2008 to 2012 trading period of the EU Emissions Trading Scheme, COM(2005)703 final. This simplicity would be diminished by expanding the credits used in the scheme to 'ICERs' and 'tCERs' issued to projects begun until 2012 under the Kyoto Protocol's Clean Development Mechanism. The treatment of land-use and forestry from 2013 will only be decided as part of negotiations on the second commitment period. This review concerns the EU emissions trading scheme from 2013, and the Commission does not wish to pre-empt agreement in the context of the UNFCCC and Kyoto Protocol on the treatment of land use and forestry. The EU is engaged in discussions on a number of approaches to land-use, land-use change and forestry from 2013 under the UNFCCC.

greenhouse gas emission reductions, and invites the Commission to further explore and develop its recommendations as part of a broad stakeholder process¹¹. It is the view of the Commission that the review process should be driven by the principles of environmental efficiency, while taking account of the cost-effectiveness of the measures proposed. The Commission also notes that while there is growing consensus on the key strategic issues for review, more experience and evaluation is needed to address them. The Commission will therefore intensify consultations with stakeholders on these strategic issues throughout 2006 and aims at proposing amendments to the Directive in 2007. The review will also contribute to the EU's position in the international negotiations for addressing climate change beyond 2012, at the end of the first Kyoto commitment period. The Commission considers that market-instruments should play a key role in the future international system.

3.2 The next step - European Climate Change Programme Working Group on the Review of the EU ETS

The European Climate Change Programme is a multi-stakeholder consultative process, in which experts from the Commission, Member States, academics, industry and the NGO community work together¹². Five working groups dealing with various issues of European climate policy¹³ have already been set up under the ECCP's second phase (the "ECCP II"). The Commission's further consultations on the review of the EU ETS will take place within the pre-existing ECCP sub-group on emission trading. The working group will make use of available high-quality inputs in order to develop and rank options to address the strategic issues identified to improve the functioning and cost-effectiveness of the scheme in delivering greenhouse gas emission reductions.

The Commission invites interested parties to communicate further views and share practical experience gained in the implementation of the EU ETS. It will also draw upon the Member States' annual reports under Article 21 of the Directive and the European Environment Agency's technical report on the application of the Emissions Trading Directive by EU Member States¹⁴ based on these reports. Other important sources of information are the recommendations on the EU ETS review expressed by the High Level Group on Competitiveness, Energy and the Environment in June 2006 and the output of a LIFE-project¹⁵ on the EU ETS.

To focus the review process, the Commission has identified a number of issues that can be grouped into four categories, namely (1) the scope of the Directive, (2) further harmonisation and increased predictability, (3) robust compliance and enforcement and (4) links to third countries. A more detailed summary of each of these categories is set out in the Terms of Reference of the Working Group (see Annex).

¹¹ http://ec.europa.eu/enterprise/environment/hlg/doc_06/first_report_02_06_06.pdf

¹² COM(2000) 88 final, COM(2005) 35 final.

¹³ WG 1: ECCP I Review, WG 2: Impacts and Adaptation, WG3: Carbon Capture and Geological Storage, WG4: Aviation, WG5: Integrated approach to reduce CO2 emissions from light-duty vehicles.

¹⁴ http://reports.eea.europa.eu/technical_report_2006_2/en/technicalreport_2_2006.pdf

¹⁵ The reports of the monitoring project will be posted on the Commission's webpage: <http://ec.europa.eu/environment/climat/emission.htm> The reports of the LIFE-project "LETS Update" are posted on this webpage: <http://www.environment-agency.gov.uk/business/444217/590750/590838/1294204/1295326/1291719/?version=1&lang=e>

(1) The scope of the Directive

The original scope of the Directive was driven by the objective of achieving "critical mass" for the introduction of a trading scheme. The selected activities covered large stationary sources where monitoring of emissions could be done with sufficient accuracy.

In the review, the Commission is addressing the scope of the EU ETS. Firstly, it will consider streamlining the application of the current scope, notably as regards combustion installations and the smallest installations. There has been significant debate about the fact that Member States have applied different interpretations of a "combustion installation" as mentioned in Annex I to the Directive. The review will explore how to give further clarity on specific types of combustion installation and their coverage under the Directive. The cost-effectiveness of covering small installations in the EU ETS will also be considered in the review.

Secondly, the review will look at expanding the EU ETS to other sectors and gases including N₂O from the production of ammonia and CH₄ from coal mines. The Commission will also assess to what extent to recognise carbon dioxide capture and geological storage activities in the EU ETS.

Moreover, the extension of the EU ETS to other sectors and gases should be part of a comprehensive and coherent policy mix¹⁶, and it must be ensured that these alternative policies are effective in contributing towards reductions in greenhouse gas emissions.

(2) Further harmonisation and increased predictability

In the original design of the EU ETS, most of the initial tasks related to the allocation of allowances are foreseen to be carried out at national level. The Directive created the National Allocation Plans (NAPs) as the tool by which each Member State proposes how many allowances to allocate for a period (setting the cap) as well as how these allowances should be distributed among existing installations and potential new entrants (allocation). In addition to ensuring application of the EC Treaty rules, the Commission is mandated to ensure that NAPs comply with a number of allocation criteria set out in Annex III to the Directive. These criteria, which have been subject to guidance by the Commission¹⁷, continue to apply for the periods after 2012¹⁸ unless amended.

The result of this nationally-driven process is that the national allocation plans differ from each other and many stakeholders have raised concerns that such differences are having an impact on the internal market. The Commission takes the view that a number of options exist to harmonise the treatment of new entrants, and that having new entrants buy allowances in the market or in an auction is in accordance with the principle of equal treatment.

¹⁶ As regards road and maritime transport, inclusion of direct emissions would involve much greater administrative costs.

¹⁷ COM (2003)830 and COM (2005)703.

¹⁸ The reference in criterion (1) to Decision 2002/358/EC may, however, need to be updated.

Being in theory able to go back to the drawing board prior to each allocation period means that certainty can only be given for up to five years ahead. This is considered by many as too short to give sufficient predictability for investment decisions in sectors which are capital intensive and result in installations intended to be operated for decades. The Commission shares these views and regards further harmonisation of the cap-setting and allocation process, as well as increased predictability, as key strategic issues. The review will explore the option of a single EU-wide cap and that of separate national caps after 2012 determined by each Member State, and will explore specific issues related to auctioning and benchmarking. Another important task is to find cost-effective solutions for providing information to the market on a more structured and regular basis so as to ensure optimal market transparency.

(3) Robust compliance and enforcement

Robust compliance and enforcement procedures are important for the good functioning of the scheme, not least in view of linking with schemes in third countries. While initial experience of the learning-by-doing phase of the scheme with respect to compliance and enforcement has been encouraging, there is nevertheless a need to assess further harmonisation requirements.

As regards monitoring and reporting of emissions, it will be considered whether the monitoring and reporting guidelines should be laid down in a Regulation in order to aid harmonised application of the legislation. As regards third party verification of emissions reports produced by companies and the accreditation process for approving organisations to act as verifiers, many stakeholders have expressed a preference or even stressed the need for more elaborated provisions at Community level. The need for additional compliance provisions will also be considered.

(4) Linking with emissions trading schemes in third countries, and appropriate means to involve developing countries and countries in economic transition

As regards the relationship of the EU ETS to schemes in third countries, the design of third country emissions trading schemes that are in operation or planned, and the possibility of linking third country schemes with the EU ETS will be considered. The review will consider extending arrangements for linking emissions trading schemes to other mandatory emission trading schemes in third countries capping absolute emissions at national or regional level.

The Directive provides for the continued recognition of credits from the Kyoto Protocol's project-based mechanisms beyond 2012. Regulatory certainty is important for companies, and the Commission is committed to maintaining recognition of these credits. The involvement of developing countries and countries in economic transition in emissions abatement efforts through respectively the Clean Development Mechanism and Joint Implementation and the extent to which emission reduction projects to date are contributing to countries shifting to more sustainable development paths will therefore be assessed.

3.3 Institutional and procedural aspects

The introduction of the EU ETS and the establishment of an international carbon market bring with it new institutional needs both at Community and Member State level. For instance, some Member States have established a specialised agency dedicated to the implementation of the EU ETS. Institutional arrangements give rise to administrative costs, which in principle should be kept as low as possible.

Some of the options to address the strategic issues identified above would result in a considerable number of additional tasks to be undertaken at Community level to implement the EU ETS after 2012 (e.g. administration of an EU-wide new entrant reserve, approval process for projects not conducted in accordance with the Linking Directive, administration of EU-wide allowance auctions, development of EU-wide benchmarks).

The Commission will therefore review also the existing institutional arrangements at both Community and Member State level with a view to adapting them to new needs arising out of the review and identifying areas where administrative costs could be further reduced (e.g. a single EU registry) and also invites stakeholder comments in this regard.

Procedurally, the Commission will consider the need for improvements regarding the notification and assessment of national allocation plans.

3.4 The relationship between the EU ETS and other market-based regulatory instruments

The relationship between the EU ETS and other policies and measures that pursue the same objective is most obvious in the case of taxes levied on energy products and electricity, which are harmonised by Council Directive 2003/96/EC (the “Energy Tax Directive”). Greenhouse gas emissions trading and energy taxation are different economic instruments, operating by different legal means but partially pursuing the same objectives, in particular as concerns targeted CO₂ taxes. The energy tax directive foresees that under certain conditions taxation can be fully or partially replaced, in particular for energy intensive companies, by some other instrument, including tradable permit schemes. This possibility is subject to the applicable State aid provisions. The EU ETS limits emissions of covered installations in the EU collectively, and until 2012 the Directive requires most allowances to be allocated free of charge.

In line with its commitments, the Commission will consider further the interplay of the EU ETS with other measures pursuing the same objectives, and in particular with energy taxation. The earliest occasions for this will be the discussions on the review of the Emissions Trading Directive and the planned Green Paper on the use of indirect taxation and other market based instruments for Community policy purposes.

4. CONCLUSION

The first phase of the EU ETS has proved to be a valuable learning period not only as a basis for Member States' national allocation plans for the second trading period

2008 to 2012, but also to inform the review of the scheme. The Commission welcomes the submissions already received from stakeholders and the willingness to openly discuss all aspects of the scheme, and looks forward to continued constructive discussions within the framework of the Working Group on the EU ETS review under ECCP II. It is of utmost importance that the EU ETS, as a market-based instrument, is streamlined and expanded as appropriate so that greenhouse gas emissions can be reduced in a cost-effective manner and so that it can serve as a role model for schemes in other parts of the world.

ANNEX

Terms of reference of the Working Group on the EU emissions trading scheme for the review of the Directive under the European Climate Change Programme II

The purpose of the working group is to advise the Commission services on the review of the EU ETS that will lead to amendments to the Directive being proposed in 2007. The working group will consist of experts from Member States and key stakeholder organisations, including industry, trade unions, consumer and environmental organisations. The Commission will chair the working group. It will also decide on admissions to the group. Meetings will take place on a regular basis in Brussels.

Taking into account experience gained during the first two years of emissions trading, the working group will consider the following issues and submit its conclusions in the form of a report by 30 June 2007.

(1) The scope of the Directive

- The group will explore how to give further clarity on specific types of **combustion installations** that are covered by Directive 2003/87/EC, building on the Commission's 2005 Communication on further guidance on allocation plans for the 2008 to 2012 trading period of the EU Emissions Trading Scheme. As necessary, the group will also develop more specific technical descriptions of such additional types of combustion installations with a view to facilitating harmonised application by Member States, potentially building upon work already done in this regard by Member States for the purpose of second phase national allocation plans.
- The group will explore alternative ways to further improve the cost-effectiveness of the participation of **small installations** in the scheme. It should furthermore be determined whether there is sufficient justification for removing certain small installations from the scope of the EU ETS, taking into account that emissions from small installations, if removed, would have to be addressed by other policies and measures achieving the same environmental results. Moreover, the group will explore whether it is possible to define a workable threshold (general or activity-specific) below which an installation's cost of participating in the scheme exceeds the environmental benefits of having that installation in the scheme. In doing so, it shall take into account the nature of the costs, i.e. whether they are one-off costs for setting up the initial systems and infrastructure or whether they are recurring costs. If the group recommends a workable threshold, it should be determined whether there is a need to facilitate the participation of installations below such threshold(s) in the EU ETS, taking into account the revised monitoring and reporting guidelines to be adopted shortly.
- As regards **other sectors and gases**, the group will firstly assess the feasibility of including N₂O from the production of nitric acid for which stakeholder input indicates that there is widespread support while stressing the need to set up a benchmark. In addition, the group will assess the desirability and feasibility of including, for example, the following sectors (other than to the extent CO₂

emissions from combustion installations are already covered in these sectors) and gases: CO₂ from the production of petrochemicals, CO₂ and N₂O from the production of ammonia, other fertilisers than nitric acid and adipic acid, CO₂ and PFCs from the production of aluminium and CH₄ from coal mines, taking into account all relevant environmental, economic, social, health and administrative impacts. Other sectors may also be looked at as appropriate.

- The group will consider the **unilateral inclusion of additional activities and gases** by Member States, possibly in a harmonised manner, under Article 24 of the Directive and whether the modalities and procedures for such inclusion continue to be appropriate.
- The group will assess to what extent to recognise **carbon dioxide capture and geological storage (CCS)** activities in the EU ETS, having regard to the need for comparable treatment of low or non-CO₂ emitting activities and a level playing field both between various CCS options and across the EU for investment in CCS technologies. The ECCP II Working Group on CCS recommends that, during 2007, the Commission produces a Communication outlining the major EU policy choices for CCS, accompanied, where appropriate, by a proposal for an EU regulatory framework for CCS.
- Finally, after considering the above-mentioned options to further extend the scope of the scheme, the group may consider the desirability and feasibility of introducing a Community-level approval process for emission reduction **projects within the Community** not already covered by Directive 2004/101/EC. Any such consideration in the group would firstly focus on which activities could be covered by Community projects, on the basis that the direct emissions from these activities are not suitable for a system with emission caps, and secondly on the activities that have a substantial potential to reduce greenhouse gas emissions. As part of this analysis, the group would take into account all relevant environmental, economic, social, health and administrative impacts. If still considered both desirable and feasible, the group may then explore modalities and procedures for establishing Community-level harmonised provisions for administering such project activities.

(2) Further harmonisation and increased predictability

- As regards the **setting of the cap** the working group will explore the option of a single EU-wide cap and that of separate caps after 2012 determined by each Member State. For the option of a single EU-wide cap the group will explore alternative means to set this cap, taking into account the need to further reduce the EU's greenhouse gas emissions in order to contribute to limiting the global annual mean surface temperature increase to 2°C above pre-industrial levels, and that reduction pathways for developed countries in the order of 15-30% by 2020, compared to the baseline envisaged in the Kyoto Protocol, are to be considered¹⁹. For the option of separate national caps the group will explore the advantages and drawbacks of deciding them up-front in the Directive or setting these caps through national allocation plans. In order to increase predictability,

¹⁹ European Council Brussels 22-23 March 2005 – Presidency Conclusions, paragraph 43.

the group will explore whether the cap should be set for a longer period (e.g. 10 or 15 years) or whether a permanent structure, calculation, or elements of a calculation, should be developed for the cap with periodic allocation decisions at installation level.

- As regards **allocation of allowances to sectors and installations** the group will explore which (mix of) more harmonised allocation methodologies should be applied in future trading periods. As regards the sector level, it will be explored whether there is a need to use sector-specific allocation methodologies. In this context, the degree of pass-through of allowance prices in product prices should also be considered. In order to increase objectiveness and transparency, further harmonisation should be explored for the rules on allocation at installation level. It should, e.g., be considered whether to abolish allocations based on projections and whether allocations should continue to be based on emissions data in a historic base period or rather/also on efficiency parameters.
- The group will explore specific issues related to auctioning (e.g. what share, nationally coordinated or EU-wide auctions, auction schedules, auction design, market impacts). For the option of separate national caps the group should assess whether there should be a harmonised minimum of auctioning after 2012, and what share might be suitable. For the option of a single EU-wide cap, full auctioning should be considered as a possibility. The group will consider specific issues related to benchmarking (e.g. applicability to which sectors, national or EU-wide benchmarks, number of factors to be taken into account by sector / number of benchmarks needed by sector, whether benchmarks should be based on input (e.g. fuel use) or output (e.g. cement produced) data, availability of necessary data, issues related to transparency of input or output data). The group will take into account the need for simplicity and predictability of the allocation methodology, a level playing field in the internal market, and international aspects.
- As regards **predictability** the group will explore whether the design of the EU ETS should be periodically revisited in the future and if so in what intervals, and whether developing a permanent structure for the cap or setting the cap for a longer period needs to be complemented by equal time horizons for allocation at sector and installation level.
- As regards **new entrants**, in the first trading period all Member States have chosen to set aside some allowances in the national allocation plan in a reserve to allocate for free to new entrants. However, the size and the exact rules governing access to and allocation out of these reserves differed considerably across Member States. The group will explore harmonised approaches to new entrants with a view to further strengthening incentives for investment into low emitting technologies and to ensure closely comparable conditions of competition across the EU. The working group will consider whether not creating a reserve for new entrants is a suitable approach for all or some sectors taking into account the temporary status of an installation as a new entrant, the degree of competition from outside the EU and the climate policy these competitors are subject to. Alternatively, the setting aside of some allowances in a reserve to be allocated for free (for some sectors) could be continued. However, the allocation from such a reserve should for internal market reasons

be harmonised, either by adopting common rules or by constituting and administering the reserve at EU level. The working group will assess these options taking into account the possibility of longer allocation periods, the need for simplicity, low administrative burden, and appropriate incentive effects including considering if these options are neutral between different technologies and energy sources. The group will also assess the appropriateness of the definition of a new entrant in the Directive. As a corollary to the new entrants provisions, harmonisation of provisions for installations that close during a trading period will be looked at.

- The group will explore options for a harmonised approach for **installations that close** during a trading period (including consideration of EU-wide administrative rules on closure and cross-border transfer) taking into account the findings on new entrants and the need for simplicity, low administrative burden, and appropriate incentive effects.
- As regards **monitoring and reporting**, the group will explore different cost-effective solutions for providing information to the market on actual emissions on a more structured and regular basis so as to ensure optimal market transparency.

(3) **Robust compliance and enforcement**

- As regards **monitoring and reporting** of emissions, the group will consider whether the monitoring and reporting guidelines should be laid down in a Regulation in order to aid harmonised legislative application, possible revisions and extensions to the Annex of the Directive laying down principles for monitoring and reporting in order to further specify monitoring requirements, and explore other means (including the use of advanced information technology applications) to ensure EU-wide uniform standards of application in practice of monitoring and reporting.
- The group will consider Member States' practices for the **verification** of emission reports and accreditation of verifiers under the EU ETS. In doing so, it shall take into account the forthcoming results of the evaluation of the first EU ETS verification cycle and explore options to ensure improved stringency and oversight of the verification and accreditation process in all Member States. This could include whether a Community-level accreditation process for verifiers should be developed, taking into account the work of the European Co-operation for Accreditation. From an internal market perspective, and also to increase the number of verifiers available for companies in a Member State, the group will also consider other means to enable verifiers to operate in other Member States than the one in which they were accredited, including procedures for the granting and revocation of mutual recognition. Finally, the group will also consider whether an EU-wide Regulation for verification and accreditation should be laid down to achieve these objectives.
- The group will consider the need for additional **compliance provisions**. This will include provisions for enforcement (including site visits) of the rules governing and results of the verification process, and further harmonisation of Member States' existing compliance provisions, *inter alia* in relation to non-

submission of verified emission reports, the late submission of verified emission reports, errors in verified emission reports, and inaccuracies in data reported for the purposes of allocation.

(4) **Linking with emissions trading schemes in third countries, and appropriate means to involve developing countries and countries in economic transition**

- As regards the relationship of the EU ETS to schemes in third countries, the group will consider the design of third country emissions trading schemes that are in operation or planned, and the possibility of linking third country schemes with the EU ETS. It should also consider whether the Directive's provisions for concluding agreements with ratifying Parties listed in Annex B to the Kyoto Protocol should be extended to cover other arrangements in respect of mandatory emission trading schemes capping absolute emissions at national or regional level within third countries which have yet to ratify the Protocol, and at national or regional level within third countries which have ratified the Protocol. The group will explore means and arrangements to provide for such an extension.
- The group will assess the involvement of **developing countries and countries in economic transition** in emissions abatement efforts through respectively the Clean Development Mechanism and Joint Implementation and the extent to which emission reduction projects to date are contributing to economies shifting to more sustainable development paths. In this light, it shall consider ways to strengthen these countries' participation in emissions abatement activities and consider Community-level arrangements for the authorisation of projects in order to ensure fuller harmonisation. In addition, the group will consider the possibility of further harmonising the types of Kyoto Protocol project credits that are accepted by Member States for compliance with obligations under the Directive, and consider harmonising the percentages of Kyoto Protocol project credits accepted by Member States for compliance with obligations under the Directive.