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Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending the Directive establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms

(presented by the Commission)

{SEC(2003) 785 }

EXPLANATORY MEMORANDUM

1. GENERAL REMARKS.

1.1 Political context of the Proposal

Joint Implementation (“JI”) and the Clean Development Mechanism (“the CDM”), together with international emissions trading, are innovative instruments provided for in the Kyoto Protocol¹. These so-called “Kyoto flexible mechanisms” enable Parties to meet part of their Kyoto targets by taking advantage of opportunities to reduce greenhouse gas emissions in other countries at lower cost than at home. The rationale is that, from the global environmental point of view, the place where the emission reduction takes place is of secondary importance provided that real emission reductions are achieved. Rules, modalities and guidelines for implementation of the Kyoto Protocol’s mechanisms were agreed at the 7th Conference of the Parties to the UNFCCC (COP7, November 2001) as part of the so-called “Marrakech Accords”.

This proposal will boost JI and the CDM by providing additional incentives for business to engage in these mechanisms. It thereby promotes technology transfer to industrialised countries, for example Russia, and to developing countries while reducing the costs of meeting commitments under the EC emissions allowances trading scheme established under Directive 2003/.../EC. The proposal sends a strong signal to other Parties to the Kyoto Protocol that the Community is fully committed to the Kyoto flexible mechanisms and the advantages that they entail for both the Community and other Parties. At the same time, industrialised countries have a responsibility to reduce their emissions of greenhouse gases through domestic measures, given their historic levels of emissions and current higher *per capita* emissions than developing countries. This underpins the principle of complementarity, that industrialized countries are to take significant action at home to meet their reduction commitments and use the Kyoto Protocol’s mechanisms to meet only part of these commitments. This principle is enshrined in the Marrakech Accords and the EU has always defended this principle. It is important for the EU to continue to take the lead in tackling climate change, not least by implementing the principle of complementarity. This proposal finds a balance between the goal of promoting JI and CDM on the one hand and the concern for their complementarity to domestic emission reduction measures on the other, taking into account that this measure by itself cannot guarantee complementarity as it does not affect the use that Member States may make of the Kyoto flexible mechanisms, i.e. JI, CDM and emissions trading between Parties. However, the Community has a special responsibility in respect of its own legislative instruments.

1.2. The Kyoto Protocol’s project based mechanisms - Joint Implementation and the Clean Development Mechanism

JI and the CDM are “project-based”, and allow the generation of credits when projects achieve emission reductions that are additional to what would have occurred in the absence of the project (the “baseline” scenario). Such projects need to result in real, measurable and long term benefits related to the mitigation of climate change, while contributing to the achievement of sustainable development goals of host countries, notably through the transfer

¹ Adopted in 1997, the Kyoto Protocol supplements and strengthens commitments set forth under the UN Framework Convention on Climate Change (UNFCCC)

of environmentally sound technologies. JI and the CDM differ to the extent that projects take place in countries with different commitments and, consequently, they are subject to different project cycle requirements under the Marrakech Accords.

JI projects are to be undertaken in developed countries or countries with economies' in transition (Annex I Parties to the UNFCCC). They involve at least two countries that have accepted an emission target, i.e. their emissions are limited. Emission reductions from JI projects are called *emission reduction units* ("ERUs") and issued by the country in which the project is implemented (the "host country"). The implementation of a JI project results in a transfer of ERUs from one country to the other, but the total emissions permitted in the countries remains the same (a "zero sum operation"). The host country benefits from minimising the part of its assigned amount to transfer, while the investor country benefits from maximising the number of assigned amount units it acquires. It is expected that both countries will strike a fair balance. Because of this balance, a less strict control procedure is required under the Marrakech Accords. JI is expected to be a good vehicle for the transfer of advanced environmentally sound technologies, in particular in Russia where there is a great potential for JI investments in the energy sector.

JI projects can also be implemented between two Member States of the European Community. In such a case the environmental effect as regards greenhouse gas emissions is even a zero-sum game within the Community. The interaction between the Community emission allowance trading scheme and such potential projects is of increasing importance.

The Kyoto Protocol provides for CDM projects to be hosted by developing countries (non-Annex I Parties to the UNFCCC, without quantitative emission reduction targets). Annex I Parties can use CDM credits to offset an increase in their domestic emissions during a commitment period. Therefore, an additional level of assurance is required regarding the validity and amount of emission credits resulting from CDM activities. This difference is reflected in the Marrakech Accords. CDM implementation is supervised by a UNFCCC body, the CDM Executive Board, which is responsible for issuing CDM credits called *certified emission reductions* ("CERs"). The CDM is expected to be an excellent vehicle for the transfer of advanced environmentally sound technologies to developing countries, while assisting them in achieving their sustainable development objectives, such as poverty alleviation and sectoral economic reform.

Parties are responsible to meet their Kyoto commitments but it is mainly the private sector that is expected to drive JI and the CDM. So far, the private sector has been hesitating about JI or the CDM because of uncertainties related to the entry into force of the Kyoto Protocol. 110 Parties, representing more than two-thirds of the world's population, have ratified the Kyoto Protocol but JI and CDM will not come into existence until the Protocol enters into force. Lesser factors that have caused the private sector to hesitate include potential transaction costs and risks associated with early implementation of JI and the CDM, and the lack of capacity and institutions in many potential host countries to select and approve projects. In addition, aside from a market for purchases by governments, as long as companies are not subject to an obligation to reduce their own greenhouse gas emissions at domestic level, it is likely that the private sector engagement in JI and the CDM will remain limited.

1.3. Linking JI and the CDM to the Community emission allowance trading scheme to lower the costs of reducing greenhouse gas emissions within the EU while contributing to global sustainable development.

On 18 March 2003, the Council adopted a Common Position² on a Directive establishing a scheme for greenhouse gas emission allowance trading within the Community in order to promote reduction of greenhouse gas emissions in a cost-effective manner within the EU. Final adoption of this Directive is expected in 2003.

This scheme places direct emissions of greenhouse gases within a regulatory framework where the total quantity of emissions is limited. Starting in 2005, the scheme will require large carbon dioxide emitters (power and heat generation and energy intensive industry) to match the emission from their installations with allowances allocated through national allocation plans. The Community scheme gives installations' operators flexibility either to invest in abatement technology or to acquire EU allowances on the market to match their emissions, whichever is the cheaper. The Community scheme will contribute towards the cost-effective fulfilment of the EU's commitments under the Kyoto Protocol³. The Common Position does not provide for the inclusion of JI or CDM credits.

The core element of this proposal is to provide the recognition of JI and CDM credits as equivalent to EU emission allowances for their use within the Community scheme by operators to fulfil their obligations. Linking will increase the diversity of compliance options within the Community scheme thereby leading to a reduction of compliance costs for installations in the scheme. Linking will improve the liquidity of the European market in greenhouse gas emissions allowances and lower the market price for them. It is estimated that annual compliance costs in the period 2008-12 for covered installations in the enlarged EU will be reduced by –more than 20%. Allowance prices in the enlarged EU with linking as proposed are estimated to be lowered by about half.

This proposal will stimulate the demand for JI credits, in particular from Russia because of the great potential for projects there, and will lead to more investments by EU companies and the development and transfer of advanced environmentally sound technologies and know-how. By stimulating demand for CDM credits it will also assist developing countries hosting CDM projects in achieving their sustainable development goals through the transfer of environmentally sound technologies and know how. It will contribute towards the fight against climate change through implementation of the Kyoto Protocol and the UNFCCC.

The proposal is based on Article 175(1) of the Treaty, as its overall objectives are to promote activities reducing greenhouse gas emissions in a cost-effective manner while contributing to global sustainable development, and because it amends the EC emissions trading Directive which is based on the same Article.

Linking JI and the CDM to emissions trading has been the subject of extensive discussions and analysis in the multi-stakeholder European Climate Change Programme (ECCP), that this proposal draws upon. In particular, the ECCP Working group on JI and the CDM (2002)

² Council Document 15792/02

³ The EC and its Member States are all Parties to the UNFCCC. The EC ratified the Kyoto Protocol pursuant to Council Decision 2002/358/EC of 25 April 2002 concerning the approval on behalf of the European Community of the Kyoto Protocol to the UNFCCC and the joint fulfilment thereunder (OJ 15 May 2002, L130, page 1). The EC and its Member States ratified the Kyoto Protocol on 31 May 2002 and are committed to reduce their greenhouse gas emissions by 8% below 1990 levels by 2008-2012.

expressed strongly the view that linking JI and the CDM to the Community emission allowance trading scheme is desirable and practicable in as far as the environmental integrity of the emissions trading scheme is not undermined and on condition that consistency with the Kyoto Protocol and the Marrakech Accords is preserved.

The proposal also creates synergies with European research through the Community's RTD Framework Programmes. European research supports technologies to address climate change the transfer of which to other industrialised and to developing countries will be promoted by JI and CDM.

1.4. The form and the structure of the proposal.

Since the main objective is to recognise JI and CDM credits for allowing their use within the Community emission allowance trading scheme, the proposal is for a Directive amending Directive 2003/.../EC establishing the Community scheme. It introduces the necessary conditions to do it while preserving the architecture, the simplicity and the environmental integrity of the scheme. By consolidating existing legislation, it is the most coherent way to achieve the policy objective while reducing implementation costs.

Linking JI and the CDM to the Community scheme implies the creation of a bridge between two different frameworks. JI and the CDM are project-specific, based on a baseline and credit approach with an *ex-post* verification of emissions reductions achieved, while the Community scheme is a “cap and trade” programme for the reduction of greenhouse gas emissions based on *ex-ante* allocation of emission allowances to covered installations. This proposal reflects the fact that these two frameworks differ in many aspects (different institutions involved for the issue of emission allowances and credits, different timing for the implementation, different units of account).

The starting point is that JI and CDM credits are recognised as being equivalent to EU emission allowances from an environmental and economic point of view. Consequently, the proposal does not modify the project cycles through which JI and CDM credits are issued. It means that the proposal is based on trust *vis-à-vis* the Kyoto system and the competent institutions, in particular the CDM Executive Board and the Article 6 Supervisory Committee. It introduces some safeguards as to what to link and how much to link in order to operationalise the Marrakesh Accords and preserve the environmental integrity of the Community scheme.

The proposal also transposes into Community law some internationally agreed principles, criteria and project requirements so as to ensure that these are observed in projects authorised by the Community and its Member States. Enabling these requirements to be enforceable in Community law is important to ensure that the Community and its Member States fulfil their commitments and because such JI and CDM credits are likely to constitute the majority of credits used within the Community scheme.

2. THE RECOGNITION PROCESS: THE CONVERSION OF JI AND CDM CREDITS INTO ALLOWANCES

Central to the proposal lies the concept of conversion by Member States of JI and CDM credits, respectively “ERUs” and “CERs”, into allowances, the unit of account within the Community scheme. On request to their competent authority, operators can obtain allowances converted from CERs and ERUs they have either generated themselves or purchased on the

market.⁴ The conversion shall take place through the issue of allowances by the Member State in exchange for CERs and ERUs held by that operator in its national registry. The allowances would come in addition to those allowances allocated in national allocation plans to operators under the Community scheme. Operators will be able to convert JI and CDM credits in any Member State that foresees such a conversion.

The conversion of CERs and ERUs into allowances has a number of advantages, for Member State authorities and for companies participating in the Community scheme. This will create certainty for companies participating in the emissions trading scheme as they will be able to use allowances converted from CERs or ERUs in exactly the same manner as any other allowances that they have been initially allocated or have acquired, in order to fulfil their obligations under the Community scheme. The absence of any additional restrictions on use or banking by entities thus provides full fungibility of companies' holdings within the Community emission allowance trading system. This also provides more certainty about which credits are accepted for compliance and lower transaction costs through simplicity.

Directive 2003/.../EC makes clear (in recital 9) that, from 2008, transfers of allowances will involve corresponding adjustments of Assigned Amount Units under the Kyoto Protocol, and this will be provided for in the Regulation on Registries adopted pursuant to Article 19 of that Directive. For Member States, exchange of CERs and ERUs for allowances linked to Assigned Amount Units will facilitate the implementation of the Kyoto Protocol's restrictions on the use and carry-over of JI and CDM credits (up to a maximum 2.5% of a Party's assigned amount respectively into the 2013-2017 period⁵).

3. CONDITIONS FOR THE RECOGNITION OF JI AND CDM CREDITS

Under the proposal, the competent authorities can convert CERs and ERUs from project activities that comply with the following conditions:

3.1. Quantitative conditions

Although providing an unlimited access to JI and CDM credits may have positive economic effects, it may at the same time undermine the environmental integrity of the Community emission allowance trading scheme. Linking with JI and the CDM will allow an increase in emissions in sectors covered by the scheme and will affect the emission trajectories of installations using these credits. By this "outsourcing" of emission reductions outside the EU the environmental co-benefits from further greenhouse gas emission reductions in the form of e.g. lowered sulphur or nitrogen dioxide emissions are foregone. Furthermore, it would discourage initiatives for the reduction of emissions within the EU. By putting a downward pressure on the market price, it could also have a perverse effect by retarding technological development of the most promising emission reduction technologies within the EU while these are necessary for fighting against climate change over the medium to long-term.

These concerns are recognised in the Kyoto Protocol, which requires that "*The acquisition of ERUs shall be supplemental to domestic actions for the purposes of meeting commitments*"⁶, and that "*Parties ... may use the certified emission reductions accruing from such project*

⁴ The award of ERUs or CERs by a Member State to an operator without payment corresponding to the market value may constitute state aid and would require a notification to the Commission.

⁵ Decisions 16/CP.7 and 17/CP.7).

⁶ Article 6(1)(d) of the Kyoto Protocol, on JI

*activities to contribute to compliance with part of their ... reduction commitments*⁷". The Marrakesh Accords also require "*that the use of the mechanisms shall be supplemental to domestic action*"⁸. Developing countries want industrialised countries to take significant action to reduce their emissions at home and, although they are interested in investment through the CDM, they will be unwilling to take on greater commitments to combat climate change unless industrialised countries take significant action to reduce domestic emissions.

While the Community and its Member States have agreed internationally that "*use of the mechanisms shall be supplemental to domestic action*", the Community scheme creates an EU-wide market where allowances can be traded without restriction. This means that Member States cannot take individual decisions on what credits to recognise or not in the context of the Community scheme. It is therefore necessary to closely monitor the level of JI and CDM credits converted for use in the Community scheme, and have a provision in this proposal for a review to be undertaken to ensure if necessary that the Marrakesh Accords are respected, as this cannot be done by the Member States individually in respect of the Community scheme. The proposal therefore provides for a review to automatically take place once the number of CERs and ERUs converted for use in the Community scheme reaches 6% of the total quantity of allowances allocated by the Member States. In this case, the Commission may consider whether a maximum level of for example 8% of the total quantity of allowances should be introduced for the remainder of the period, to ensure supplementarity under the Kyoto Protocol in respect of the Community scheme and to preserve the overall objective of the Community scheme to achieve emission reductions within the EU. The introduction of such a quantitative condition would be done through the committee carrying out tasks in relation to Directive 2003/.../EC, because of the practical need for this decision to be taken during the relevant trading period.

This monitoring provision does not constrain the quantity of credits converted for the time being, with the exception of the exclusion of credits from sinks projects (see Section 3.2 below). It will therefore allow the operators covered by the Community emissions trading scheme to reap the full benefits of linking JI and CDM to the Community scheme. These benefits are estimated to amount to halving the allowance price from € 26 without the linking to under € 13 and an annual cost saving for the installations covered by the Community scheme of € 700 million in the enlarged EU. The emissions of these installations would be allowed to rise by some 111 million tonnes of CO₂ equivalent as compared to the baseline without the linking.

This proposal does not regulate the use of JI or CDM credits by Member States or by private individuals in respect of commitments outside of the Community scheme, and it remains the responsibility of Member States to ensure supplementarity in these areas. For this reason, the Commission's recent proposal for a monitoring mechanism of Community greenhouse gas emissions and the implementation of the Kyoto Protocol⁹ requires Member States to report on how their use of JI and the CDM is supplemental to domestic actions. It also does not prevent EU private sector entities to generate, hold, or transfer CERs and ERUs beyond any quantitative limit. CERs and ERUs not converted into EU allowances retain their commercial value as Kyoto compliance instruments for Member States and other Parties to the Kyoto Protocol.

⁷ Article 12(3)(b) of the Kyoto Protocol, on the CDM

⁸ Decision 15/CP.7: "Principles, nature and scope of the mechanisms pursuant to Articles 6, 12 and 17 of the Kyoto Protocol"

⁹ COM(2003) 51 final

It is estimated that in the absence of limits on the conversion as foreseen in this proposal, the JI and CDM credits used in the Community scheme will amount to an estimated 7% of initially allocated allowances for the 2008-2012 period. The level of 6% of the total quantity of allowances allocated, which will trigger the review, is estimated to correspond to some 2% of the EU base year emissions. This would represent more than a quarter of the total 8% emission reductions the EU has to achieve in order to meet its target under Kyoto. The maximum level of 8% that the Commission would consider when the 6% trigger threshold has been reached corresponds to an estimated 2.7% of the EU base year emissions, or one third of the Community's target under the Kyoto Protocol. Monitoring - will be -provided for by the Registries Regulation at the point of time where CERs and ERUs are converted into EU allowances and appropriate public access will be provided to information on amounts converted in the Member States¹⁰. Taking into account that Member States may make use of the flexible mechanisms under the Kyoto Protocol in addition to the conversion of JI and CDM credits following this proposal, these thresholds are considered necessary to ensure the complementarity of the flexible mechanisms to domestic emission reduction efforts inside the EU.

3.2. Qualitative conditions:

- **Avoiding double counting of emissions covered by the Community emission allowance trading scheme and emission reductions from project activities**

By placing direct emissions from certain activities in a regulatory framework where the total quantity of emissions are capped, the Community emission allowance trading scheme does not risk “double counting”. As a result of the harmonised and consistent coverage of the power and heat generation sector, Member States may not allocate any allowances to installations generating power from carbon-free sources or to installations consuming power, heat or steam (indirect emitters).

Double counting in the context of linking project credits to the Community trading scheme might happen, though, if ERUs were issued as a result of emission reductions generated through projects undertaken within the Community that also lead directly or indirectly to a reduction or limitation in emissions from an installation covered by the Community emission trading scheme. Double counting needs to be prevented both from the environmental and economic point of view. Generating ERUs, while freeing up allowances at the same time, implies a loosening of the overall cap, as ERUs exchanged into allowances entitle the holder to increase emissions to the same amount as they have been reduced via a JI project. Economically, double counting would distort competition in the liberalised European power market. While existing carbon-free sources would not receive any allowances in the initial allocation in the framework of the national allocation plans, new investments in carbon-free sources can not be awarded ERUs for conversion into allowances either.

Double counting should be forbidden following the principle that one tonne of emissions shall be accounted for only once and a reduction of it not be rewarded more than once. For that reason, an installation covered by the Community scheme cannot be, at the same time, eligible under JI. This problem is very likely to arise with JI projects undertaken in the energy supply and demand sector in Acceding countries.

¹⁰ See in particular Article 20(3) of Directive 2003/.../EC

To avoid double counting, the proposal requires that no ERUs be issued for reductions that affect directly or indirectly emissions at installations covered by the Directive 2003/.../EC. Article 6 of the Kyoto Protocol requires Parties involved to approve JI projects. The requirement for Member States not to approve projects which may result in double counting of emissions is consistent with this Article of the Kyoto Protocol. Double-counting of emissions would give a host Member State interest greater difficulties to comply with its Kyoto target, and it is important to regulate this issue at Community level in order to preserve the environmental integrity of the trading system based on an accurate accounting of emissions and to avoid distortions of competition (e.g. in the liberalised EU electricity market). The proposal invites the Committee carrying out tasks in relation to Directive 2003/.../EC to develop guidelines on the avoidance of double counting.

- **Temporary exemption for JI activities in Acceding countries**

The Commission acknowledges the efforts made by certain Member States and candidate countries in implementing JI at an early stage. Many Acceding countries will join the EU on 1st May 2004 and, by then, the Community scheme will be part of the *acquis communautaire*. The proposal gives the possibility to temporarily exempt JI activities that would normally fall under the scope of emissions trading Directive 2003/.../EC which are approved before 31 December 2004 or, where later, the date of a country's accession to the EU, to be continued as JI projects and generate ERUs until 31 December 2012. However, with the view of avoiding any double counting of emissions, the proposal requires that, in respect of such project activities, no allowances shall be allocated in the national allocation plan in respect of emission reductions resulting from those project activities.

The main reason is that the "transformation" of an on-going JI project into an installation subject to allowance trading may result in legal and contractual difficulties for both the investor and the host country that have made a bilateral arrangement for the acquisition and transfer of ERUs. Under the Community scheme, it is the Member State where the installation is located that is responsible in allocating allowances to the operator. Consequently, it is up to the country hosting the on-going JI project to decide whether this activity should temporarily be exempted from the trading scheme or not. It could decide not to do so and allocate allowances on the basis of the baseline that was initially designed for the JI project.

- **Exclusion of credits generated from certain activities from the possibility to convert them into allowances for use in the Community scheme**

This proposal does not regulate the use of JI or CDM credits by Member States or by private individuals in respect of commitments outside of the Community emissions trading scheme. The Community scheme creates an EU-wide market where allowances can be traded without restriction, meaning that Member States cannot take individual decisions on what credits to recognise or not to recognise. It is therefore necessary to take a common approach to project activities in the context of the Community scheme.

The proposal excludes JI and CDM credits from being converted into allowances for use in the Community scheme from projects that do not achieve permanent emission reduction from sources (emitters) -and could result in significant impacts on bio-diversity. It is agreed in the Marrakesh Accords (Decisions 16/CP.7 and 17/CP.7) that Annex I Parties are to refrain from using CERs and ERUs generated from nuclear facilities to meet their commitments under Article 3(1) of the Kyoto Protocol. Article 3(1) contains a legally-binding commitment for Annex I Parties to ensure that their emissions do not exceed their emission limitation and reductions commitments inscribed in Annex B to the Kyoto Protocol. It also contains a

collective goal for all Annex I Parties to have a view to reducing their overall emissions by at least 5 per cent below 1990 levels in the period 2008-12. This collective goal originally formed part of a separate article but was added to Article 3(1) in the later stages in the negotiations. The Kyoto Protocol clearly foresees legally-binding commitments for Annex I Parties under Article 3(1) extending beyond 2012. This is clear from Article 3(9) of the Kyoto Protocol, which provides for Annex B to be amended to establish commitments for subsequent commitment periods that take effect through Article 3.1. It follows therefore that the commitment on Annex I Parties to refrain from using CERs and ERUs generated from nuclear facilities has been fixed until 2012 and provides an indication for the continuation for subsequent periods.

JI and CDM credits that may be generated through land use, land use change and forestry (LULUCF) activities are also excluded from recognition. LULUCF activities can only temporarily store the carbon, which will at some time be released into the atmosphere. They are not covered by the Community emission allowance trading scheme, which aims at achieving permanent reductions from emission sources. The Community trading scheme is very much designed as a technological driver for long term emission abatement improvements from energy and industrial sources. Recognising credits from LULUCF activities would not be consistent with the approach taken by the Council and the European Parliament on emissions trading. Furthermore, there are still many uncertainties as to how to account for and monitor emission removals by sinks under the Kyoto Protocol, both under JI and the CDM, at country -and at project- levels. It is not clear how the temporary and reversible nature of LULUCF carbon sequestration can be reconciled with entity-level emissions trading, as this would have to involve the attribution of subsequent releases of greenhouse gases to the beneficiary from the initial sequestration. Negotiations are currently in progress for the design of modalities for the inclusion of afforestation and reforestation under the CDM, and these will not be agreed internationally before the 9th Conference of the Parties to the UNFCCC (December 2003) at the earliest. In the light of the application of these modalities, the Commission will give due consideration to whether and, if so, how credits from LULUCF activities could be used in entity-level emissions trading in the Community scheme. In addition, the JI and CDM should bring technology transfer through, for example, the promotion of new, cleaner technologies and improvements in energy efficiency, while afforestation and reforestation activities do not bring technological transfer or development. Because sinks projects are expected to be cheaper than projects involving the transfer of technologies, allowing credits from such projects to be converted would be at the expense of promoting technological transfer to other industrialised and developing countries which is key to the JI's and CDM's success and the long-term goal of stabilising global levels of greenhouse gas emissions.

Subject to the double counting provisions for JI projects in the Community, the proposal recognises the possibility to convert JI and CDM credits from hydro power plants. However, Member States and other industrialised countries should take account of environmental and social impacts of project activities in which they participate or which are undertaken by legal entities they authorise to participate, which should avoid projects entailing negative environmental and social impacts, in particular from large hydro-electric power production as identified by the World Commission on Dams¹¹. The review that takes place in 2006 of the Community emissions trading scheme should examine the extent to which large hydro-electric

¹¹ See final report of the World Commission on Dams: *Dams and Development: A New Framework for Decision-Making*, published in November 2000.

power production projects have been established which may have negative environmental and social impacts.

3.3. Timing conditions and consequences

JI and CDM credits are accepted for use in the Community emissions trading scheme as from 2008, which implies equal treatment of these two project mechanisms. Under Article 12(10) of the Kyoto Protocol on the CDM, CERs obtained before the first commitment period (2008-2012) can be used to assist in achieving compliance in the first commitment period. Therefore, providing in EC law for -CDM credits to be used pre-2008 would not be in line with the Kyoto Protocol's approach. The certainty of the acceptance after 2008 of CDM credits generated before then to meet obligations under the EC scheme will nonetheless give an additional stimulus for the CDM at an early stage and can therefore be expected to reduce transaction costs and lower risks associated with investing in CDM projects.

As far as JI credits are concerned, the Marrakech Accords¹² stipulate that ERUs shall only be issued for a crediting period starting after the beginning of the year 2008. This means that JI credits cannot exist before 2008. Consequently, the proposal does not foresee the exchange of ERUs into allowances in the 2005-2007 period, for the simple fact that no ERUs will be available prior to 2008.

4. LINKS WITH EXISTING COMMUNITY ENVIRONMENTAL LEGISLATION AND THE EU STRATEGY ON SUSTAINABLE DEVELOPMENT

4.1. Requirement to take account of the *acquis communautaire* for the establishment of baselines for project activities undertaken in countries having signed an Accession Treaty with the EU

Under the Kyoto Protocol, JI and the CDM must achieve additional reductions to those that would have happened otherwise, and the Marrakech Accords state that a baseline shall be established taking into account relevant national policies and circumstances, such as sectoral reform initiatives, local fuel availability, power sector expansion plans, and the economic situation in the project sector¹³. Wherever the country hosting JI or CDM projects have a legislation setting precise requirements that have an impact on greenhouse gas emissions, this legislation should be fully taken into account for the purpose of baseline setting. Acceding countries are committed to align their national laws, rules and procedures with the entire body of EC legislation, the so-called *acquis communautaire* at the latest by accession, with the exception of some transition measures agreed within the accession negotiations and recorded in the Treaty of Accession. EC legislation requirements shall be seen as part of the baseline for JI projects undertaken in those countries.

¹² Decision 16/CP.7 Guidelines for the implementation of Article 6 of the Kyoto Protocol

¹³ Decision 16/CP.7 Guidelines for the implementation of Article 6 of the Kyoto Protocol: "*The baseline (...) is the scenario that reasonably represents the anthropogenic emissions by sources (...) that would occur in the absence of the proposed project. A baseline shall cover emissions from all gases, sectors and source categories listed in Annex A to the Kyoto protocol (...) within the project boundary*".

4.2. Requirement to take account of environmental and social impacts of project activities in which Member States are involved

The Marrakech Accords affirm that it is the host country's prerogative to confirm whether JI and CDM projects assist it in achieving sustainable development. It is the Member States' responsibility to approve JI and CDM projects in which they or their legal entities are involved.

The proposal states that Member States shall take account of environmental and social impacts of project activities in which they participate or which are undertaken by legal entities they authorise to participate in. It is a general requirement that applies both to project preparation (before project approval) and project implementation (when emission reductions are monitored and verified). This requirement is consistent with the Marrakech Accords whereby much discretion exists for Member States, whether social and environmental criteria on CDM and JI projects should be taken into account before they give their approval on projects. Taking account of economic, social and environmental impacts in the project approval process will ensure that approved JI and CDM projects effectively contribute to sustainable development. Since participation in JI and the CDM is voluntary, the proposal includes an encouragement to the private sector to enhance corporate environmental and social responsibility and accountability in accordance with the Plan of Implementation agreed at the World Summit on Sustainable Development in Johannesburg.

4.3. Public access to information on JI and CDM project activities

In accordance with Directive 2003/4/EC on public access to environmental information, the requirements of the Aarhus Convention and the requirements on public information set forth by the Marrakech accords, including through national registries¹⁴, this proposal ensures that information on project activities is also made available to the public. This provision applies to projects outside the territory of the Community in which a private entity participates, as this participation is under the responsibility of the Member State.

4.4. Environmental impact assessment of national strategies/programmes for JI/CDM implementation

The proposal states that Member States shall assess the environmental impacts that may result from national strategies or programmes for the implementation of JI/CDM projects and to consult the public prior to their adoption. This provision implements both the Aarhus Convention and the Directive 2001/42/EC of 27 June 2001 on the assessment of the effects of certain plans and programmes on the environment (Strategic Environmental Assessment for policies, plans and programmes (SEA)).

4.5. Possibility for EMAS verifiers to verify emission reductions from JI project activities within the Community

Only designated operational entities that are accredited by the CDM Executive Board can validate projects and/or verify and certify emission reductions under the CDM.

¹⁴ See in particular Section E of the Annex to the draft Decision -/CMP.1 on modalities for the accounting of assigned amounts under article 7.4 of the Kyoto Protocol.

Under the “fast-track” procedure for JI (when the host party meets all participation requirements provided for in Section D of Decision 16/CP.7), Annex I Parties can decide who to designate for verifying emission reductions.

The proposal gives to Member States the opportunity to designate environmental verifiers that are involved in EMAS to verify emission reductions from JI fast track activities within the Community. The advantage is to benefit from existing accreditation bodies and procedures established in accordance with Article 4 of Regulation 761/2001/EC¹⁵ of 19 March 2001 of the EMAS Regulation. However, beyond a sound knowledge on climate change issues, environmental verifiers under EMAS would have to demonstrate that they have the necessary expertise and understanding of the JI project cycle requirements.

5. CO-ORDINATION WITH MEMBER STATES’ NATIONAL DESIGNATED AUTHORITY FOR THE IMPLEMENTATION OF JI AND THE CDM

With a view to better implementation, the proposal recommends full co-ordination between the competent authority for the implementation of the emissions trading Directive 2003/.../EC¹⁶ and the designated national authority for the implementation of JI and CDM projects in accordance with the Marrakech Accords¹⁷.

6. THE CASE OF RENEWABLE ENERGY PROJECTS

The replacement of power and heat production from conventional fossil fuels with renewable energy sources is an important option to reduce greenhouse gas emissions from power and heat production.

The Community emission allowance trading scheme does not specifically address renewable energy as it does not emit carbon dioxide emissions. Renewable energy benefits from the fact that no allowances need to be obtained and surrendered for producing renewable-based power and heat, while such allowances imply increased opportunity costs for those producers using fossil fuels like coal, oil or natural gas. These increased opportunity costs will be reflected in market prices for power and heat to the benefit of renewable-based producers.

It is expected that many renewable energy projects will be proposed as Kyoto project activities, in particular under the CDM. These projects will greatly contribute to climate change mitigation and could help some countries to adapt themselves to the adverse effects of climate change. There is a great potential to create synergy with the objective of poverty alleviation. It is worth noting that the Parties to the UNFCCC recently adopted (COP8, Delhi, India) simplified modalities for small-scale CDM projects, including renewable energy projects with a maximum output capacity equivalent of up to 15 megawatts. This will greatly

¹⁵ Regulation 761/2001/EC of 19 March 2001 allowing voluntary participation by organisations in a Community Eco-management and audit scheme (EMAS), see accreditation requirements in Annex V.

¹⁶ Article 18

¹⁷ Decision 16/CP.7, §20(a) and Decision 17/CP.7, §29

facilitate the implementation of renewable energy projects under the CDM while minimising transaction costs.

However, renewable energy facilities that may affect emissions from installations covered by the Community emission allowance trading scheme will not be eligible under JI within the EU because of the double counting provision.

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directive 2003/.../EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 175(1) thereof,

Having regard to the proposal from the Commission¹⁸,

Having regard to the opinion of the European Economic and Social Committee¹⁹,

Having regard to the opinion of the Committee of the Regions²⁰,

Acting in accordance with the procedure laid down in Article 251 of the Treaty²¹,

Whereas

- (1) Directive 2003/.../EC of the European Parliament and the Council²² establishes a scheme for greenhouse gas emission allowance trading within the Community in order to promote reductions of greenhouse gas emissions in a cost effective and economically efficient manner, recognising that in the longer-term, global emissions of greenhouse gases will need to be reduced by approximately 70% compared to 1990 levels. It aims at contributing towards fulfilling the commitments of the Community and its Member States to reduce anthropogenic greenhouse gas emissions under the Kyoto Protocol which was approved by Council Decision 2002/358/EC of 25 April 2002 concerning the approval, on behalf of the European Community, of the Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC) and the joint fulfilment of commitments thereunder²³.
- (2) Directive 2003/.../EC states that the recognition of credits from project-based mechanisms for fulfilling obligations as from 2005 will increase the cost-effectiveness of achieving reductions of global greenhouse gas emissions and shall be provided for

¹⁸ OJ C [...], [...], p.[...].

¹⁹ OJ C [...], [...], p.[...].

²⁰ OJ C [...], [...], p.[...].

²¹ OJ C [...], [...], p.[...].

²² OJ C [...], [...], p.[...].

²³ OJ L 130, 15.5.2002, p. 1.

by provisions for linking the Kyoto project-based mechanisms including Joint Implementation (JI) and the Clean Development Mechanism (CDM) under the Kyoto Protocol with the Community greenhouse emission trading scheme (“the Community scheme”).

- (3) Linking the Kyoto project-based mechanisms to the Community scheme, while safeguarding its environmental integrity, gives the opportunity to use emission credits generated through project activities eligible under Article 6 and 12 of the Kyoto Protocol in order to fulfil operators’ obligations under Article 12 (3) of Directive 2003/.../EC. As a result, this will increase the diversity of low cost compliance options within the Community scheme leading to a reduction of overall costs of compliance with the Kyoto Protocol while improving the liquidity of the Community market of greenhouse gas emissions allowances. By stimulating demand for JI credits Community companies will invest in the development and transfer of advanced environmentally sound technologies and know-how. The demand for CDM credits will also be stimulated and thereby developing countries hosting CDM projects will be assisted in achieving their sustainable development goals.
- (4) Credits from the Kyoto Protocol’s project-based mechanisms will only come into existence once the Kyoto Protocol enters into force. In addition to the use of the Kyoto project-based mechanisms by the Community and its Member States, and by companies and individuals outside the Community scheme, those mechanisms should be linked to the Community scheme in such a way to ensure consistency with the Kyoto Protocol and subsequent decisions adopted thereunder as well as with the objectives and architecture of the Community scheme and provisions laid down by Directive 2003/.../EC.
- (5) Emission credits generated through the Kyoto project-based activities should be converted into allowances under Directive 2003/.../EC so as to use a single unit of account within the Community market of greenhouse gas emissions allowances thereby recognising the equivalence between Kyoto emission credits and emission allowances.
- (6) The -quantity of emissions credits from the Kyoto project-based mechanisms - converted into allowances should be monitored and a review foreseen that can operationalise the commitments of the Community and its Member States to ensure complementarity under the Kyoto Protocol and subsequent decisions adopted thereunder in respect of the Community scheme and preserve the overall objective of the Community scheme to achieve emission reductions thereunder.
- (7) In accordance with the Kyoto Protocol and subsequent decisions adopted thereunder emission credits resulting from project activities involving nuclear facilities should not be used for meeting commitments under the Kyoto Protocol. Emission credits resulting from land use, land use change and forestry project activities should not be converted into allowances under this Directive because they do not achieve permanent emission reduction from sources.
- (8) In order to avoid double counting, emission reductions units should not be issued as a result of reductions generated through project activities undertaken within the Community that also lead to a reduction in, or limitation of, emissions from an installation covered by Directive 2003/.../EC.

- (9) In accordance with the relevant Treaties of Accession, the *acquis communautaire* should be taken into account for the establishment of baselines for project activities undertaken in countries acceding to the Union. A temporary derogation should however be allowed for on-going JI project activities approved until 31 December 2004 or, where later, the date of a State's accession to the Union, which may result in the issue of emission reduction units until 31 December 2012 provided that no allowances are allocated in the national allocation plan in respect of emission reductions resulting from these project activities.
- (10) Approval of Kyoto project activities prior to their implementation is the responsibility of Member States. In considering their approval, Member States should ensure that these project activities achieve additional emission reductions and result in real, measurable and long term benefits related to the mitigation of climate change, while contributing to the achievement of sustainable development goals of host countries, notably through the transfer of environmentally sound technologies, in accordance with the Kyoto Protocol and any decision adopted thereunder, to the specific development needs and objectives of host countries, and to poverty eradication.
- (11) In line with the European Union Strategy on Sustainable Development²⁴, this Directive requires that environmental and social impacts that may result from JI and CDM project activities should be taken into account when projects are prepared and implemented in order to ensure that they will effectively contribute to sustainable development.
- (12) In accordance with the UNFCCC, the Kyoto Protocol and any subsequent decision adopted for their implementation, the Commission and the Member States should support capacity building activities in developing countries and countries with economies in transition in order to help them take full advantage of JI and the CDM in a supportive manner with their sustainable development strategies.
- (13) Since participation in JI and CDM project activities is voluntary, corporate environmental and social responsibility and accountability should be enhanced in accordance with paragraph 17 of the World Summit on Sustainable Development Plan of implementation²⁵. In that regard, companies should be encouraged to improve social and environmental performance of JI and CDM activities in which they participate.
- (14) The public should have access to information on project activities and be consulted when national programmes for JI and CDM projects implementation are developed prior to their adoption.
- (15) Member States' National Programmes for the implementation of JI and the CDM should take into due consideration relevant Community policy, in particular Community economic development and aid co-operation, and be in accordance with Community rules on competition and public procurement.
- (16) Directive 2003/.../EC should therefore be amended accordingly.

²⁴ COM(2001)264 final.

²⁵ Adopted by the World Summit on Sustainable Development, held in Johannesburg, South Africa, from 26 August to 4 September 2002. See http://www.johannesburgsummit.org/html/documents/summit_docs/2309_planfinal.htm.

- (17) The measures necessary for the implementation of this Directive should be adopted in accordance with Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission²⁶.
- (18) Since the objective of the proposed action, the establishment of a link between the Kyoto project-based mechanisms and the Community scheme, cannot be achieved by the Member States acting individually, and can therefore by reason of the scale and effects of the proposed action be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective,

HAVE ADOPTED THIS DIRECTIVE:

Article 1
Amendments to Directive 2003/.../EC

Directive 2003/.../EC is hereby amended as follows:

1. In Article 3, the following points are added:
 - (k) “Annex I Party” means a Party listed in Annex I to the UNFCCC that has ratified the Kyoto Protocol as specified in Article 1(7) of the Kyoto Protocol;
 - (l) “project activity” means a project activity approved by one or more Annex I Parties in accordance with Article 6 or Article 12 of the Kyoto Protocol and the decisions adopted thereunder;
 - (m) “emission reduction unit” (ERU) means a unit issued pursuant to Article 6 of the Kyoto Protocol and the decisions adopted thereunder;
 - (n) “certified emission reduction” (CER) means a unit issued pursuant to Article 12 of the Kyoto Protocol and the decisions adopted thereunder.
2. The following Articles are inserted after Article 11:

“

Article 11(bis)

Conversion of CERs and ERUs from project activities for use in the Community scheme

1. Following the entry into force of the Kyoto Protocol and subject to paragraphs 2 and 3 of this Article, Member States may convert CERs and ERUs from project activities into allowances for use in the Community scheme during each period referred to in Article 11(2) of this Directive, at the request of an operator. This shall take place through the issue of one allowance by the

²⁶ OJ L 198, 17.7.1999, p. 23.

Member State in exchange for one CER or ERU held by that operator in its national registry.

2. At such time as the number of CERs and ERUs from project activities converted for use in the Community scheme reaches 6% of the total quantity of allowances allocated by the Member States for the period, the Commission shall undertake an immediate review. In the light of this review, the Commission may consider whether a maximum of for example 8% of the total quantity of allowances allocated by the Member States for the period should be introduced in accordance with the procedure in Article 23(2).
3. All CERs and ERUs may be converted for use in the Community scheme except from the following project activities:
 - (a) In accordance with the Kyoto Protocol and subsequent decisions adopted thereunder, nuclear facilities; and
 - (b) Land use, land-use change and forestry

Article 11(ter)
Project activities

1. Member States shall take all necessary measures to ensure that baselines for project activities, as defined by subsequent decisions adopted under the Kyoto Protocol, undertaken in countries having signed a Treaty of Accession with the Union fully comply with the *acquis communautaire*, including the temporary derogations set out in the Treaty of Accession.
2. Except as provided for in paragraph 3, Member States hosting project activities shall ensure that no ERUs are issued for reductions or limitations of greenhouse gas emissions from installations covered by this Directive.
3. Until 31 December 2012, emission reductions resulting from project activities which fall under the scope of this Directive and which are approved before 31 December 2004 or, where later, at the date of the State's accession to the Union may result in the issue of ERUs. In respect of such project activities, no allowances shall be allocated in respect of emission reductions resulting from those project activities.
4. Member States shall take all necessary measures to ensure that the preparation and implementation of project activities in which they participate or authorise private or public entities to participate that are undertaken outside the territory of the Community take into account the environmental and social impacts of those projects. They shall also ensure that these projects are developed and implemented in such a manner to contribute to sustainable development, and to the specific development needs and objectives of the host countries.
5. In considering approval of project activities in accordance with Articles 6 and 12 of the Kyoto Protocol and decisions adopted thereunder, Member States shall ensure that project activities result in:

- (a) real, measurable and long term benefits related to the mitigation of climate change;
 - (b) reductions in emissions that are additional to any that would occur in the absence of the proposed project activity; and
 - (c) the transfer of environmentally safe and sound technology and know-how.
6. Provisions for the implementation of paragraphs 1 to 5 shall be adopted in accordance with Article 23(2).

”

3. In Article 17 the following paragraph is added:

“Information on project activities in which a Member State participates or authorises private or public entities to participate, held by the competent authority, shall be made available to the public by that authority subject to the restrictions laid down in Article 3(3) and Article 4 of Directive 2003/4/EC.”

4. The following article is inserted after Article 17:

“Article 17(bis)

Strategic impact assessment of national JI and CDM implementation programmes

Member States shall assess the environmental impacts that may result from their national strategies or programmes for the implementation of projects and consult the public prior to their adoption in accordance with Directive 2001/42/EC of the European Parliament and of the Council²⁷, in particular Article 6 thereof.”

5. In Article 18 the following paragraph is added:

“Member States shall in particular ensure co-ordination between their designated focal point for approving projects pursuant to Article 6, paragraph 1(a) of the Kyoto Protocol and their designated national authority for the implementation of Article 12 of the Kyoto Protocol respectively designated in accordance with subsequent decisions adopted under the Kyoto Protocol.”

6. In paragraph 3 of Article 19 the following sentence is added:

“That Regulation shall also include provisions concerning the conversion of CERs and ERUs for use in the Community scheme and on monitoring of the level of such conversion.”

7. Article 21 is amended as follows:

- (a) In paragraph 1 the second sentence is replaced by the following:

²⁷ Directive 2001/42/EC of 27 June 2001 on the assessment of the effects of certain plans and programmes on the environment

“This report shall pay particular attention to the arrangements for the allocation of allowances, the conversion of ERUs and CERs for use in the Community scheme, the operation of registries, the application of the monitoring and reporting guidelines, verification and issues relating to compliance with the Directive and on the fiscal treatment of allowances, if any.”

(b) Paragraph 3 is replaced by the following:

“3. The Commission shall organise an exchange of information between the competent authorities of the Member States concerning developments relating to issues of allocation, the conversion of ERUs and CERs for use in the Community scheme, the operation of registries, monitoring, reporting, verification and compliance.”

8. The following article is inserted after Article 21:

“Article 21(bis)

In accordance with the UNFCCC, the Kyoto Protocol and any subsequent decision adopted for their implementation, the Commission and the Member States shall endeavour to support capacity building activities in developing countries and countries with economies in transition in order to help them take full advantage of JI and the CDM in a supportive manner with their sustainable development strategies and to facilitate the engagement of entities in JI and CDM project development and implementation.”

9. Article 30 is amended as follows:

(a) in paragraph 2 the following point is added

“(k) the impact of project mechanisms on host countries, particularly on their development objectives, including whether JI and CDM large hydro-electric power production projects have been established which have negative environmental and social impacts;”

(b) paragraph 3 is deleted.

10. In Annex V the following point is added:

“(13) Verifiers accredited in accordance with the procedure and criteria laid down in Regulation (EC) No 761/2001 of the European Parliament and of the Council allowing voluntary participation by organisations in a Community Eco-Management and Audit Scheme (EMAS) which have the necessary expertise and experience in greenhouse gas mitigation activities can be verifiers for project activities eligible under Joint Implementation undertaken within the Community.”

Article 2
Implementation

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 30 September 2004 at the latest. They shall forthwith inform the Commission thereof.

When Member States adopt these measures, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. The methods of making such reference shall be laid down by the Member States.

2. Member States shall communicate to the Commission the text of the provision of national law, which they adopt in the field covered by this Directive. The Commission shall inform the other Member States thereof

Article 3

This Directive shall enter into force on the day of its publication in the *Official Journal of the European Union*.

Article 4

Addressees

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament
The President

For the Council
The President