

Linking the EU Emissions Trading Scheme to JI, CDM and post-2012 International Offsets

A legal Analysis and Critique of the EU ETS and the Proposals for its Third Trading Period

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ABSTRACT

The so-called ‘Linking’-Directive adopted in 2004 does not impose any limit on the import of JI/CDM credits under the European Union Emissions Trading Scheme (EU ETS), but requires from the Member States to set, in accordance with their ‘supplementarity’ obligations under the Marrakesh Accords, the maximal amount of Kyoto ‘units’ each covered installation is entitled to use for compliance under the scheme. Fearing a second price collapse of the European Union Allowance, the Commission decided, however, in 2006 to impose strict limits on the use of JI/CDM credits during the second trading period. This paper examines the legal basis of the Commission’s decision and explores further the international and European legal framework within which the current debate on the use of JI/CDM credits and post-2012 international offsets takes place. It analyses in particular the recent proposal of the Commission on the third trading period of the EU ETS and the related report of rapporteur Doyle of the European Parliament and discusses the necessity to introduce quantitative and qualitative restrictions on the use of international offsets within the EU ETS against the backdrop of the international negotiations on a new global deal on climate change.

KEY WORDS

EUROPEAN UNION, EUROPEAN POWER INDUSTRY, CLIMATE CHANGE, INTERNATIONAL OFFSETS, KYOTO PROTOCOL

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Introduction

The so-called 'Linking'-Directive adopted in 2004 doesn't impose any limit on the import of JI/CDM credits under the European Union Emissions Trading Scheme (EU ETS), but requires from the Member States to set, in accordance with their 'supplementarity' obligations under the Marrakesh Accords, the maximal amount of Kyoto 'units' each covered installation is entitled to use for compliance under the scheme. Fearing a second price collapse of the European Union Allowance, the Commission decided, however, in 2006 to impose strict limits on the use of JI/CDM credits during the second trading period. This paper examines the legal basis of the Commission's decision and explores further the international and European legal framework within which the current debate on the use of JI/CDM credits and post-2012 international offsets takes place. It analyses in particular the recent proposal of the Commission on the third trading period of the EU ETS and the related report of rapporteur Doyle of the European Parliament and discusses the necessity to introduce quantitative and qualitative restrictions for the use of international offsets within the EU ETS against the backdrop of the international negotiations on a new global deal on climate change.

While the international discussions about a global and comprehensive post-2012 agreement to fight climate change started in Bali in December 2007, the first trading period of the European Union Emissions Trading Scheme (EU ETS) has come to an end. Its environmental effectiveness is highly contested, as Member States, facing a type of 'Prisoner's Dilemma'¹, were unable to resist the temptation to hand out generous emissions allowances, causing the collapse of the price of the European Union Allowance (EUA)² at the end of 2006 and reducing to zero the incentives to abate emissions and to develop alternative fuels and more energy-efficient technologies. The question naturally arises as to whether the second (2008–2012) and third trading periods (2013–2020) of the EU ETS will witness a more positive environmental outcome.

Although the European Commission³ has cut the proposed amount of allowances (the 'cap') for the second trading period by about 10%, many analysts⁴ expect the shortage of

¹ The Prisoner's Dilemma results from the fact that all Member States will benefit when emission reductions goals are met but each Member State has an incentive to over-allocate allowances to in-state firms providing them an opportunity to become net sellers to the emissions credit market. See Kurkowski (2006: 716).

² An EUA is equivalent to one tonne of CO₂.

³ Hereafter the 'Commission'.

⁴ See The World Bank (2008: 9), Openeurope (2007), WWF (2007).

allowances to be covered entirely by the import of cheap credits of often dubious environmental effectiveness from the Kyoto Protocol's project mechanisms.⁵ There is indeed growing concern that a significant part of the credits generated by the JI⁶ and CDM⁷ do not reflect real, verifiable emission reductions and that the CDM in particular is inadequate to assist developing countries in bringing about structural changes to reduce their dependence on fossil fuels.⁸

This would mean that the principal legal instrument adopted by the EU to fight climate change neither encourages investments leading to a progressive decarbonisation of the industries covered in the EU nor significantly helps developing countries in their transition towards a low-carbon economy as required by the Bali Action Plan.⁹

While the critique regarding the inability of the Kyoto Protocol's project mechanisms to contribute effectively to long-lasting reductions of greenhouse gas emissions will not be discussed at length, this study sheds some light on the rules which govern the use of CDM and JI credits and post-2012 international offsets¹⁰ within the current EU ETS and in the proposals for its third trading period.¹¹

After a brief account of the debate preceding the adoption of the 'Linking' Directive¹², which amended the ETS-Directive in respect of the Kyoto Protocol's project mechanisms, we examine its content and analyse the criteria established by the Commission in its guidance on the ETS¹³ at the end of 2006 to limit their use in the second trading period. We then present the international and European legal framework within which the current debate on the use of JI/CDM credits and post-2012 international offsets, which are also

⁵ The Kyoto Protocol's project mechanisms are the CDM and the JI. CDM stands for clean development mechanism and JI for joint implementation. CDM and JI projects lead to the emission of so-called 'certified emission reductions' (CERs) in the case of the CDM and 'emission reduction units' (ERUs) in the case of JI. They are commonly called the Kyoto 'units' and may be used by the Parties included in Annex B for compliance under the Kyoto Protocol.

⁶ Article 6 of the Kyoto Protocol.

⁷ Article 12 of the Kyoto Protocol.

⁸ Delbeke (2008), Wara (2008), Wara et al. (2008), Lohmann (2008), International Rivers (2008), Voigt (2008), Schneider (2007), Muller (2007), Michaelowa (2007), Pearson (2006), Egenhofer et al. (2005), De Larragan (2005), Meijer et al. (2005), Michaelowa (2005), Bygrave et al. (2004).

⁹ See FCCC/CP/2007/6/Add.1, Decision 1/CP.13, Bali Action Plan at <http://unfccc.int/resource/docs/2007/cop13/eng/06a01.pdf#page=3>

¹⁰ An international offset in this context represents a credit which certifies the reduction, removal, or avoidance of greenhouse gas emissions by a project taking place outside of the European Union and that is used to compensate for greenhouse gas emissions occurring in the European Union. See also for a more general definition of the meaning of an offset the Offset Quality Initiative (2008: 2).

¹¹ Although crucial for the environmental integrity of the ETS, the linkage of the EU ETS with other emission trading schemes will not be examined in this publication. See for a thorough discussion on this subject inter alia Flachslund et al. (2008), Schüle et al. (2006), Anger (2006).

¹² See Directive 2004/101/EC of the European Parliament and of the Council of 27 October 2004 amending Directive 2003/87/EC establishing a scheme for trading of greenhouse gas emission allowances within the Community, in respect of the Kyoto Protocol's project mechanisms.

¹³ European Commission (2006). Communication from the Commission to the Council and the European Parliament on the assessment of national plans for the allocation of greenhouse gas emission allowances in the second period of the EU ETS accompanying Commission Decisions of 29 November 2006 on the national allocation plans of Germany etc., COM (2006) 725.

referred to as ‘external’ credits, takes place. We discuss in particular the recent proposal of the Commission on the ETS¹⁴ and the related report of rapporteur Doyle¹⁵ of the European Parliament and evaluate their proposals in the light of the scientific findings presented by the 2007 IPCC¹⁶ and the international commitments made by the EU at the UNFCCC Conference in Bali.¹⁷ Finally, we conclude with an outlook on the debate regarding the use of offsets by emission trading schemes in the United States.

I. The use of CDM and JI credits within the EU ETS

The EU ETS, launched in January 2005, is an EU-wide ‘cap-and-trade’ scheme for CO₂ emissions from energy-intensive industry, covering about 45% of greenhouse gas emissions in the EU. Its legal framework is set out by the Directive, which established a scheme for trading in greenhouse gas emission allowances within the Community (‘ETS-Directive’).¹⁸ The scheme distinguishes between two distinct trading periods: phase I, a three-year period from 1 January 2005 until 31 December 2007, and phase II, a five-year period, coinciding with the Kyoto Protocol commitment period, starting 1 January 2008 and ending in 2012.¹⁹ Its aim is to help Member States reduce their greenhouse gas emissions to meet their targets under the Kyoto Protocol at minimum costs. The scheme itself does not set an upper limit (the ‘cap’) to the number of allowances, but leaves that decision to the Member States, which have to fix the maximal amount of allowances allocated to their industry in their national allocation plans (NAPs). The NAPs are submitted to the European Commission (the Commission), which has to assess them and decide whether to grant approval.²⁰ It may reject a plan, or any aspect thereof, if it finds it to be incompatible with the criteria set out in Annex III of the ETS-Directive.²¹

¹⁴ European Commission (2008). Proposal for a Directive of the European Parliament and of the Council amending the Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community. COM (2008) 16.

¹⁵ European Parliament (2008). Draft report on the proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend greenhouse gas emission allowance trading system of the Community of 11th June 2008, Committee on the Environment, Public Health and Food Safety, rapporteur Avril Doyle, (COM (2008)0016–C6-0043/2008–2008/0013(COD), the ‘Doyle’ report.

¹⁶ The Intergovernmental Panel on Climate Change (IPCC) was established in 1988 under the auspices of the United Nations Environment Programme and the World Meteorological Organization for the purpose of assessing ‘the scientific, technical and socioeconomic information relevant for the understanding of the risk of human-induced climate change’. To date, the IPCC has issued four comprehensive assessments in 1990, 1996, 2001 and 2007. More than 2500 scientists contributed to these assessments, relying mainly on published and peer-reviewed scientific technical literature. The IPCC shared the 2007 Nobel Peace Prize with former Vice President of the United States Al Gore. See <http://www.ipcc.ch>.

¹⁷ The United Nations Climate Change Conference in Bali at http://unfccc.int/meetings/cop_13/items/4049.php.

¹⁸ See Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for trading in greenhouse gas emission allowances within the Community and amending Council Directive 96/61/EC.

¹⁹ Article 9 (1) ETS-Directive.

²⁰ Article 9 ETS-Directive.

²¹ Article 9 (3) ETS-Directive.

A. The 'Linking' Directive

1. The Commission's Proposal

In its original version, the ETS-Directive did not include the possibility for operators to use Kyoto 'units' for compliance under the scheme. The importance of the project-based mechanisms in increasing the cost-effectiveness of the EU ETS was, however, already stressed in its preamble.²² On 23 July 2003, the Commission presented a proposal aiming at linking the CDM and JI mechanisms with the ETS²³, which took the form of an amendment to the ETS-Directive.²⁴ The proposal allowed for the 'conversion' of JI and CDM credits into allowances for use in the EU ETS from 1 January 2008 onwards.²⁵ No limit on the amount of credits to be converted was foreseen, but the Commission was required to undertake an immediate review by the 'comitology procedure'²⁶ in the case that the amount of credits reached 6% of the total quantity of allowances and to consider whether a maximum percentage, 'for example' 8%, should be introduced.

The most frequently invoked reason for the inclusion of the project-based mechanisms was that they reduce the compliance costs for the sectors covered under the EU ETS by broadening the range of opportunities to reduce emissions in another Member State or outside the EU at lower costs.²⁷ Another advantage is that they allow sources not covered by the ETS-Directive to engage in implementing cost-effective reduction options. Finally, the combination of emission caps and the possibility to use CDM and JI was meant to help kick-start the international carbon market. Many environmental nongovernmental organisations (NGOs) were, however, opposed to the use of JI and CDM credits within the EU ETS, because they feared that a massive import of Kyoto units into the system would significantly lower the market price of the EUA and lead to little or no domestic

²² See paragraph 19 of the Preamble of the ETS-Directive. Moreover, Article 30 of the Directive stated that the 'use of credits from project mechanisms' was one of the issues to be considered in the review of the Directive. The inclusion of a direct link with the Kyoto mechanisms was, indeed, strongly advocated by both industry and a number of Member States. See for more details on the 'linking' debate preceding the adoption of the original Directive, Lefevere (2005: 516), Hægstad Flåm (2007: 25 ff.), Klepper et al. (2005).

²³ See Lefevere (2005: 517).

²⁴ European Commission (2003). 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, COM (2003) 403.

²⁵ The conversion was to be done by Member States, which were granted the right to issue one new allowance in exchange for one CER or ERU. Under the proposal Member States kept the freedom to impose other criteria for the conversion of Kyoto credits into allowances. See Lefevere (2005: 524).

²⁶ The 'comitology procedure' in the European Union refers to the committee system, which oversees the acts implemented by the European Commission on behalf of the Council of Ministers. Amendments submitted to this procedure may be decided more quickly than those governed by the normal legislative process. See http://europa.eu/scadplus/glossary/comitology_en.htm.

²⁷ See Lefevere (2005: 521).

abatement.²⁸ They also expressed doubts about the environmental quality of the credits generated by the Kyoto Protocol's project-based mechanisms.²⁹

2. The legal framework

The final Directive, the so-called 'Linking-Directive', was adopted on 27 October 2004 after intensive debates.³⁰ It differed significantly from the Commission's proposal. Contrary to this proposal, which imposed a conversion of CDM and JI credits, operators are allowed to use CDM and JI credits directly to offset their reduction obligations under the ETS-Directive.³¹ Whereas CDM credits may be taken into account in both trading periods, JI credits can enter the scheme from 1 January 2008 onwards.³² The clause triggering a review in the case that Kyoto 'units' reach a certain percentage of overall allowances, was dropped. Member States are, instead, required to define an installation-specific limit in their national allocation plans (NAPS) in accordance with criterion 12 of Annex III of the ETS-Directive. The use of credits resulting from land use, land-use change and forestry (LULUCF or 'sinks') projects, as well as from nuclear facilities is excluded.³³ Special provisions concern the use of JI and CDM credits from projects that affect emissions from installations under the EU ETS and domestic projects, so-called 'unilateral JI'.³⁴

According to criterion 12 of Annex III of the ETS-Directive, Member States have to mention the maximum amount of Kyoto units, which may be used by operators covered by the scheme as a percentage of the allocation of the allowances to each installation. The percentage must be consistent with the Member States' 'supplementarity' obligations, which were laid down in the Marrakesh Accords.³⁵ These provisions require Annex 1 Parties to ensure that the use of the flexible mechanisms of the Kyoto Protocol is supplemental to domestic action and that domestic action constitutes a

²⁸ See Lefevere (2005: 522).

²⁹ See for a thorough analysis of the discussion on the influence of the various stakeholders on the final content of the Linking Directive Hægstad Flåm (2007: 25 ff.).

³⁰ See Directive 2004/101/EC of the European Parliament and of the Council of 27 October 2004 amending Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community, in respect of the Kyoto Protocol's project mechanisms. The modalities of the inclusion of the CDM and JI, were, indeed, highly contentious. Whereas industry and certain Member States pleaded for the full fungibility between CERs, ERUs and EUAs, many environmental NGOs opposed any linking or at least required strict limits for their use within the EU ETS. See Lefevere (2005: 520), Hægstad Flåm (2007: 25ff.)

³¹ See Article 11a ETS-Directive.

³² See for a discussion on the opportunities and threats of the inclusion of the CDM and JI in the EU ETS Lefevere (2005: 520ff.).

³³ On the insistence of the European Parliament a clause has been added, which requests CDM and JI projects regarding dams with a capacity over 20 MW to comply with relevant international guidelines.

³⁴ See Article 11b ETS-Directive.

³⁵ The Marrakesh Accords adopted by the Conference of the Parties (CoP 7) define the modalities of the use of the project-based mechanisms adopted by the Kyoto Protocol. The 'supplementarity' requirement was integrated in the Marrakesh Accords on the insistence of the European Union. See Langrock et al. (2004:6).

significant effort made by each of them to meet their targets under the Kyoto Protocol.³⁶ No precise information is, however, provided with respect to the ‘supplemental’ character of the flexible mechanisms, either by the ETS-Directive or in the Marrakesh Accords.

B. The Commission’s decision to restrict the use of JI and CDM credits in the second trading period of the EU ETS

With respect to the second trading period, the Commission indicated at the end of 2005³⁷ that Member States had to take into account the aggregate reductions in greenhouse gas emissions when evaluating the fulfilment of criterion 12 of Annex III. This meant that Member States had to consider the overall recourse to the flexible mechanisms when fixing the percentage of CDM and JI credits to be used within the EU ETS. The Commission did not however provide any information on how the ‘supplementarity’ principle should be interpreted.

It was only in its third guidance on the criteria of Annex III from November 2006 that the Commission became more assertive.³⁸ It departed from its formerly cautious attitude and announced that it would assess the NAPs in a manner which would allow the ETS ‘*to unfold its full environmental and economic potential in terms of environmental and economic benefits*’. It not only significantly reduced the caps proposed by the first batch of NAPs submitted, but provided guidance regarding the interpretation of criterion 12 of Annex III in a three-step process. It first developed a formula allowing the calculation of the overall amount of JI/CDM credits to which a Member State can have recourse between 2008 and 2012. Second, it indicated which rules Member States have to observe when fixing the limit for the use of Kyoto ‘units’ for the covered sectors. Third, it set a minimal percentage of Kyoto units any installation subject to the EU ETS is entitled to use. The criteria set out by the Commission are briefly discussed below.

1. The maximal overall use of JI and CDM credits by Member States

The Commission stated that the maximum amount of JI/CDM credits Member States were allowed to have recourse to between 2008 and 2012 would have to be calculated in relation to the ‘reduction effort’ they had to make to meet their targets under the Kyoto

³⁶ The Marrakesh Accords stipulate: ‘the use of the mechanisms shall be supplemental to domestic action and that domestic action shall thus constitute a significant effort made by each Party included in Annex I to meet its quantified emission limitation and reduction commitments under Article 3, paragraph 1. See Article 1 Draft Decision-/CMP.1 (Mechanisms) contained in Decision 15 /CP.7. See also Langrock et al. (2004: 6)

³⁷ European Commission, Communication (2005). ‘Further guidance on allocation plans for the 2008-2012 trading period of the EU Emission trading Scheme’, COM (2005) 703 final.

³⁸ European Commission (2006). Communication from the Commission to the Council and the European Parliament on the assessment of national allocation plans for the allocation of greenhouse gas emission allowances in the second period of the EU Emissions Trading Scheme accompanying Commission Decisions of 29 November 2006 on the national allocation plans of Germany etc., COM (2006) 725.

Protocol³⁹ and the so-called ‘Burden-Sharing Agreement’.⁴⁰ This ‘reduction effort’ would have to be calculated with respect to the three different baselines, the base year of the Kyoto Protocol (in general 1990), 2004 and 2010.⁴¹ Half of the highest difference between the level of greenhouse gas emissions in one of these years and the reduction target laid down in the Burden-Sharing Agreement and the Kyoto Protocol represents the maximal amount of JI/CDM credits a Member State is allowed to import. This formula fixed an effective ceiling of 50% on the number of JI/CDM credits to be used by a Member State with respect to their ‘reduction effort’.⁴²

The recourse to three different baselines to calculate the national ‘reduction effort’ seems at first sight somewhat confusing, but was probably chosen for political reasons. By allowing Member States to rely on the highest figure resulting from these calculations, the Commission was able to take into account the large diversity of Member States’ emission paths since 1990 without penalising one over the other. It thereby arguably reduced the important potential for conflict arising from its interpretation of the ‘supplementarity’ principle. Caution was indeed required, as the Commission’s interpretation is based on rather weak legal foundations. Indeed, neither the Kyoto Protocol⁴³ nor the Marrakesh Accords nor any Community instrument contains a numerical definition of the ‘supplementarity’ requirement. If it is true that the European Union during the negotiations of the Marrakesh Accords had insisted that at least half of the emission reductions to achieve compliance with the Kyoto Protocol should be realised

³⁹ According to the Kyoto Protocol the 15 ‘old’ Member States of the EU have to reduce a basket of six greenhouse gases by 8% over the period 2008–2012 with respect to their emissions in 1990. As Article 4 of the Kyoto Protocol allows groups of countries to agree on a common reduction target, the EU has subsequently redistributed this target among the different countries in a burden-sharing agreement. The ten ‘new’ Member States, which joined the EU in 2005, are only liable under the Kyoto Protocol. Malta and Cyprus have no reduction commitments at all.

⁴⁰ At the meeting of the Environment Council held on 16 and 17 June 1998, the Member States of the European Union agreed to divide the 8% emission reduction for the European Community between the Member States. Each Member State is individually responsible for reaching the specific target set under this agreement. Member States’ targets vary significantly, ranging from a reduction of 21% for Germany and Denmark to an increase of 25% for Greece. The EU burden-sharing agreement was made legally binding through its inclusion in the ratification decision, adopted by the Council on 4 March 2002. See Council Decision 2002/358/EC concerning the approval, on behalf of the European Community, of the Kyoto Protocol to the United Nations Framework Convention on Climate Change and the joint fulfillment of commitments thereunder.

⁴¹ Art. 2.3 par. 4 of the third guidance on the criteria of Annex III reads: ‘The level of effort to reduce greenhouse gases a Member State is required to undertake is determined by assessing the amount of reduction it is required to undertake in relation to base year emissions, greenhouse gas emissions in 2004, and projected emissions in 2010.’⁴¹ In the next step, half of the figure representing the highest effort is calculated. This figure is considered to be the maximum overall amount of JI/CDM credits that a Member State can make use of in addition to domestic action, while respecting its commitments to ensure that the use of the Kyoto mechanisms is supplemental to domestic action.’ See European Commission, COM (2006) 725.

⁴² It has however to be noted that the ceiling does not fix the overall domestic reduction effort of Member States as the latter remain free to engage in international trading of emission allowances, as set out under Article 17 of the Kyoto Protocol.

⁴³ See Article 17 of the Kyoto Protocol.

domestically, this limit remained controversial and did not become legally binding.⁴⁴ Moreover, it concerned the overall recourse to ‘external’ credits and thus also included credits Member States intended to acquire through emission trading according to the rules laid down in Article 17 of the Kyoto Protocol.⁴⁵ Accordingly, by interpreting the requirements of Article 12 of Annex III of the ETS-Directive as a compulsory ceiling of 50% with regard to the aggregate use of JI/CDM credits by Member States the Commission could rely neither on Community law nor on international public law.

2. The repartition of JI and CDM credits between the sectors covered by the EU ETS and the non-covered sectors

With respect to the repartition of JI and CDM credits between the covered and non-covered sectors of the EU ETS, the Commission clarified that Member States were free to choose which sectors should bear the burden of the domestic ‘reduction effort’.⁴⁶ Member States which had not purchased any Kyoto ‘units’ with government funds, and did not intend to do so, were allowed to distribute the full amount of CDM/JI credits among the installations of the covered sectors.⁴⁷ If, on the contrary, the government had purchased or intended to purchase Kyoto units, Member States were required to deduct the amount of JI/CDM credits from the overall ceiling when fixing their use within the EU ETS.⁴⁸ Regarding ‘intended’ purchases of Kyoto units, the Commission further specified that Member States had to substantiate sufficiently their intention, which meant that they had to demonstrate that an operational programme was in place and that it had taken concrete steps and committed budgetary resources for the purchase of carbon credits.⁴⁹

Finally, the Commission stated that notwithstanding the result of the criteria set out above, the limit imposed on the use of JI/CDM credits by installations under the EU ETS might not be lower than 10% of the allowances allocated to each installation. It justified this decision by arguing that it reflected ‘a reasonable balance’ between domestic reductions and incentives for operators to invest in projects in developing countries. The Commission did not substantiate this statement. In the light of the overall cap imposed on covered sectors in the second trading period this assertion is, however, problematic.

⁴⁴ The formulation proposed by the European Union during the negotiations of the Marrakesh Accords was that each party should acquire and surrender no more emission certificates from abroad than the equivalent of 50% of the difference between five times the emissions in one of the years between 1994 and 2002, on the one hand, and its number of assigned units, on the other. See Langrock et al. (2004: 6).

⁴⁵ Article 17 of the Kyoto Protocol foresees that Parties included in Annex B may participate in emissions trading for the purposes of fulfilling their commitments under Article 3 of the Kyoto Protocol.

⁴⁶ Point 2.3 reads: ‘In respect of Member States which do not intend to purchase any Kyoto units with government funds, a Member State may allow its operators covered by the Community scheme to make use of CDM/JI credits to the full amount of this limit.’ See European Commission, COM (2006) 725.

⁴⁷ This limit was to be understood as a percentage figure specified as a share of the approved cap for the trading sector. See European Commission, COM (2006) 725.

⁴⁸ Point 2.3 reads: ‘In respect of Member States which intend to purchase Kyoto units with government funds, these purchases are taken into account. The amount of JI/CDM credits that can be used by installations in the Community scheme in that Member State is reduced by the annual average amount of intended or substantiated government purchases.’ See European Commission, COM (2006) 725.

⁴⁹ See European Commission, COM (2006) 725.

Indeed, the aggregate limit to the use of JI/CDM within the EU ETS amounts to 13% of the overall cap, while the cap in the second trading period is only 6% lower than comparable 2005 emissions.⁵⁰ Accordingly, the amount of JI/CDM credits exceeds by nearly a factor of two the overall ‘reduction effort’ required by operators under the EU ETS with respect to 2005 emissions and theoretically allows the covered sectors to achieve all emission reductions outside the European Union.⁵¹

The reasons why the Commission fixed a minimum threshold of 10% of Kyoto units per ‘installation’, were probably not so much related to the necessity to strike a balance between domestic mitigation measures and investments outside the EU, but to find an acceptable compromise between ‘new’ and ‘old’ Member States. Indeed, as most ‘new’ Member States have no gap to fill with regard to their Kyoto target due to the breakdown of their economies in the 1990s, their domestic operators would not have been entitled to have recourse to any JI/CDM credits under the EU ETS according to the first two criteria set out above. Thus, by fixing a minimal threshold of 10%, the Commission ensured that the differences with respect to the use of Kyoto units in the various Member States remained within acceptable boundaries.⁵² Indeed, if operators in one Member State can use a significantly higher amount of credits than those in another Member State, the former have a competitive advantage.⁵³

Moreover, the Commission probably also tried to reduce the risk of a legal challenge⁵⁴ of its decision to reduce significantly the proposed caps of most new Member States.⁵⁵ These sometimes significant cuts had been necessary as the ‘new’ Member States had decided to increase the amount of allowances by 12.7% in the second trading period compared to 2005 emissions.⁵⁶ Thus, by allowing the operators of these Member States to have recourse to JI/CDM credits, even though they were on track to meet their targets under the Kyoto Protocol, the Commission was probably trying to compensate for the

⁵⁰ European Commission (2008a: 15), Ellerman et al. (2008: 33). With respect to verified emissions in 2007 the reduction represents 7.1%. EU-15 will undertake most of the overall 2008–2012 effort, with a cap set at 8.7% lower than verified 2005 emissions while emissions in EU-12 will be allowed to increase by 3.6% above the 2005 benchmark. See The World Bank (2008: 10).

⁵¹ EU ETS emissions have actually grown by an average of 1% per year since 2005, with a more vigorous growth in the Eastern Member States. Thus some analysts revised their forecasts slightly upward with regard to the likely shortfall in the second trading period. See for a view of analysts’ expectations on the shortfall of allowances in the second and third trading period The World Bank (2008: 9ff.).

⁵² As a matter of fact, the approach chosen by the Commission resulted in CDM/JI limits for individual Member States of 10% to 20% of approved caps. See Press release of 13.7.2007, Emissions trading: Commission adopts decisions on amendments to five national allocation plans for 2008-2012, IP/07/1094.

⁵³ See Langrock et al. (2004: 12).

⁵⁴ See for an analysis of the legal risks taken by the Commission when reducing the proposed caps for the second trading period de Sepibus (2007a: 18).

⁵⁵ For instance, the Commission reduced the proposed cap of Lithuania by 47%, of Latvia by 56%, of Estonia by 4 % and of Poland by 26.7%. Overall, the Commission cut by 10.4 % the overall caps originally proposed by the Member States, leading to a maximum of 2.098 million EUAs. See The World Bank (2008: 9 ff.).

⁵⁶ The NAPs of Bulgaria and Romania are not included in these figures as they have special circumstances due to their having recently joining the EU (in 2007). See Schleich et al. (2007: 22).

economic disadvantage resulting from the reduction of their caps.⁵⁷ This purpose is evident in particular in the case of Lithuania. This country, which has no compliance problems regarding its Kyoto target, had initially proposed to fix a limit of 10% with respect to the use of JI/CDM credits by its operators. As the Commission had reduced its proposed cap by 47%⁵⁸ it allowed, in a second decision on an amended Lithuanian NAP, an increase of the CDM/JI limit up to 20% of its cap – in clear contradiction to its own guidelines.⁵⁹

This strategy of the Commission to limit the legal challenges was, however, not entirely successful. Seven out of ten of the new Member States – but interestingly not Lithuania – started legal proceedings against the decision of the Commission with respect to their NAPs in the second trading period. Slovakia, followed by Poland, the Czech Republic, Hungary, Latvia, Bulgaria and Romania filed a legal complaint with the Court of First Instance in 2007, requesting the annulment of the Commission's decisions.⁶⁰

II. Linking the EU ETS to JI, CDM and post-2012 international offsets in the third trading period

A. The European and international legal framework

The Kyoto Protocol does not envisage any numerical reduction targets after the first commitment period ending in 2012. As a result, in the absence of any new international agreement or national commitments to limit greenhouse gases, the demand for JI and CDM credits runs the risk of decreasing progressively towards the end of the first commitment period of the Kyoto Protocol. To prevent such an outcome the European Union pledged in its Spring Council in 2007⁶¹ to unilaterally reduce its greenhouse gas emissions by 20% by 2020 compared to levels of greenhouse gases in 1990 and to

⁵⁷ See for an analysis of the approval process of the NAPs Ellerman et al. (2007), Zapfel (2007), de Sepibus (2007a).

⁵⁸ See European Commission, Decision on the 2nd NAP of Lithuania. http://ec.europa.eu/environment/climat/pdf/nap2006/20061128_lt_nap_en.pdf

⁵⁹ See European Commission, Decision on the amended 2nd NAP of Lithuania, http://ec.europa.eu/environment/climat/pdf/nap2006/lt_nap_amendment_en.pdf

⁶⁰ Case T- 32/07, Slovakia v Commission, OJ C 69 of 24.03.2007, p.29, Action brought on 7 February 2007; Case T-183/07, Poland v Commission, OJ C 155 of 07.07.2007, p.41, Action brought on 28 May 2007; Case T- 194/07, Czech Republic v Commission, OJ C 199 of 25.08.2007, p.38, Action brought on 4 June 2007; Case T-221/07, Hungary v Commission, OJ C 199 of 25.08.2007, p.41, Action brought on 26 June 2007; B T-369/07, Bulgaria v Commission, Case T-499/07, Action brought on 27 December 2007, Romania v Commission, T-483/07, OJ C 51 of 23.02.2008, p.57, Action brought on 22 December 2007, Latvia v Commission, T-369/07, OJ C 269 of 10.11.2007, p.66, Action brought on 26 September 2007. See for an analysis of these cases de Sépibus (2007a and b).

⁶¹ The reduction objective of 30% is explicitly made subject to the condition that other developed countries commit themselves to comparable emission reductions and economically more advanced developing countries make an adequate contribution. See European Council, 7224/1/07 REV 1. The Conclusions of the European Council were themselves based on a 'climate package' presented by the Commission in January 2007. See European Commission, COM (2007) 2.

endorse a 30% reduction objective in the case of the conclusion of a comprehensive international agreement on climate change for the period after 2012.

In December 2007, the Conference of the Parties of the UNFCCC⁶² (COP 13⁶³) and of the Kyoto Protocol (MOP3⁶⁴) adopted the ‘Bali Action Plan’⁶⁵ paving the way for post-2012 negotiations and aiming at the conclusion of such an agreement by the end of 2009 in Copenhagen.⁶⁶ Regarding the commitments made, the Bali Action Plan differentiates between those of developed country Parties and developing country Parties. For developed country Parties, the decision calls for ‘measurable, reportable and verifiable nationally appropriate mitigation commitments or actions, including quantified emission limitation and reduction objectives’. Due to the resistance of the delegations of the US, Canada, Japan and Russia, an indicative range of mitigation commitments by industrialised countries (25–40% reduction compared to 1990 levels) that is considered necessary by the IPCC to stay below a two-degree increase of global mean temperature, however, was not integrated into the text, but relegated to a reference in a footnote.⁶⁷

With regard to developing country Parties, the decision calls for ‘nationally appropriate mitigation action ... supported and enabled by technology, financing and capacity-building, in a measurable, reportable and verifiable manner’. Developing countries thus have a clearly worded point of reference that any commitments on their part have to be matched by clearly identifiable support from industrialised countries.⁶⁸ This requirement corresponds to a plea constantly being made by developing countries and was again highlighted at the session in Bali by the publication of a paper by the Secretariat of the UNFCCC, which stressed that investment and financial flows of US\$ 379.5 billion were necessary for mitigation as well as several tens of billions for adaptation by 2030.⁶⁹

⁶² In December 2007, a Conference held in Bali brought together representatives of over 180 countries and culminated in the adoption of the Bali Roadmap, which charts the course for a new negotiating process designed to tackle climate change, with the aim of completing this by 2009 in Copenhagen. See The United Nations Climate Change Conference in Bali at http://unfccc.int/meetings/cop_13/items/4049.php

⁶³ The COP 13 is the 13th Conference of the Parties of the UNFCCC and includes, in particular, also the US.

⁶⁴ The MOP 3 is the 3rd Conference of the Parties of the Kyoto Protocol and does not include the US, which has not ratified the Kyoto Protocol.

⁶⁵ See FCCC/CP/2007/6/Add.1, Decision 1/CP.13, Bali Action Plan at <http://unfccc.int/resource/docs/2007/cop13/eng/06a01.pdf#page=3>

⁶⁶ See for more details on the negotiation process Egenhofer et al. (2008: 25ff.), Watanabe et al. (2008: 4ff.), Ott et al. (2008: 91ff).

⁶⁷ It is important to note that the Ad hoc Working Group established in Montreal in 2005 under the Kyoto Protocol (AWG-KP) had recognised in August 2007 that the emission scenario with the highest probability to remain under a 2 degrees Celsius level increase of global mean temperature requires Annex I Parties to reduce emissions to between 25 and 40% below 1990 levels by 2020 and that these ranges would be significantly higher if emission reductions were to be undertaken exclusively by Annex I Parties. See FCCC/KP/AWG/2007/L.4, 31 August 2007, par. 7.

⁶⁸ See Ott et al. (2008: 93). The claim of developing countries to receive funds and help from industrialised countries is based on the fact that they have emitted less greenhouse gases and thus have less responsibility for climate change than industrialised countries. Moreover, they are less able to finance emissions reductions. See table of per capita emissions in Neuhoff (2008: 60).

⁶⁹ Watanabe et al. (2008: 9). In comparison the project-based emission reduction in 2007 amounted to a value of US\$ 6 billion in 2007. See The World Bank (2008: 2).

Less than a month after the conference in Bali – in January 2008 – the European Commission put forward a so-called ‘climate package’,⁷⁰ which included a proposal for a third trading period of the EU ETS (ETS-Proposal)⁷¹ and a proposal on the distribution of the emission reduction effort among the Member States (effort-sharing proposal).⁷² The ETS-Proposal takes the form of a draft amendment to the ETS-Directive and the effort-sharing proposal constitutes a draft decision. Both proposals are based on Article 251 EC Treaty, which is known as the ‘co-decision procedure’. This implies that whereas the Council and the European Parliament discuss the Commission’s proposal independently both must approve one another’s amendments and agree upon a final text in identical terms.⁷³

Whereas the effort-sharing proposal defines the contribution of Member States to meeting the Community’s greenhouse gas emission reduction commitment from 2013 to 2020 for greenhouse gas from sources not covered under the ETS-Directive, the ETS-Proposal fixes the cap for the covered sectors during this period. The two proposals also determine the share of carbon credits that may be imported, the effort-sharing proposal with respect to the non-covered sectors⁷⁴ and the ETS-Proposal regarding the covered industries. Following the decision of the European Spring Council of 2007, both proposals adopt a two-step approach. They first lay down the rules allowing the EU to reach a 20% reduction target by 2020 and, in the second step, indicate how these rules may be adapted if a global international agreement enters into force.

In its spring session in March 2008 the European Council endorsed the Commission’s ‘climate package’, considering it as ‘a good starting point’ and stated as its objective ‘to secure an ambitious, global and comprehensive post-2012 agreement on climate change at Copenhagen in 2009 consistent with the EU’s 2°C objective’ that ‘ensures scaled-up finance and investment flows for both mitigation and adaptation’.⁷⁵

⁷⁰ The package proposed by the Commission includes a Strategic Energy Technology Plan, European Commission (COM (2007) 723), a Support Scheme of Carbon Capture and Storage (CCS) (COM (2008) 13/18) and a revision of the Directive promoting the use of renewable energy sources (COM (2008)19).

⁷¹ European Commission, COM (2008) 16.

⁷² European Commission (2008). Proposal for a decision of the European Parliament and the Council on the effort of Member States to reduce their greenhouse gas emissions to meet the Community’s greenhouse gas emission reduction commitments up to 2020, COM (2008) 17..See for a step by step explanation of the co-decision procedure http://ec.europa.eu/codecision/stepbystep/text/index_en.htm.

⁷³ Under the co-decision procedure, a new legislative proposal is drafted by the European Commission. This proposal is then submitted to the European Parliament and the Council, which discuss the proposal independently. In order for the proposal to become law, Council and Parliament must approve each other’s amendments and agree upon a final text in identical terms. See for a step by step explanation of the co-decision procedure http://ec.europa.eu/codecision/stepbystep/text/index_en.htm

⁷⁴ The Commission proposes to allow the annual use by Member States of credits from greenhouse gas emission reduction projects in third countries of up to 3% of each Member State’s emissions from sources outside the ETS in 2005.⁷⁴ This quantity is equivalent to a third of the reduction effort in 2020. Each Member State is allowed to transfer the unused part of this limit to another Member State.

⁷⁵ European Council (2008). Presidency Conclusions of the European Spring Council of 13/14th March 2008, Nr. 7652/1/08, REV 1, par. 17 ff.

B. The ETS-Proposal of the European Commission

The Commission's ETS-Proposal⁷⁶ replaces the national caps with an EU-wide cap. With respect to the current ETS-Directive the scope is enlarged to include aviation, petrochemicals, ammonia and the aluminium sector as well as two new gases.⁷⁷ In the case that no international agreement is adopted, the Commission proposes to impose a 21% reduction in EU ETS sector emissions compared to 2005 by 2020, which corresponds to a reduction of 14% relative to 1990. Emission allowances are to be cut by 1.74% annually, starting from 2013. Compared to the other sectors, which have to reduce their emissions by about 10%, the reduction effort required from the EU ETS sectors is thus twice as important. Taken together, the reduction commitments result in an overall reduction of 14% compared to 2005, which is equivalent to a reduction of 20% compared to 1990.⁷⁸

The Commission proposes to increase auctioning to around 60% of the total number of allowances in 2013. Whereas full auctioning will be the rule from 2013 onwards for the power sector, free allocation will be gradually phased-out on an annual basis between 2013 and 2020 for other sectors. However, certain energy-intensive sectors will continue to get all their allowances for free if they are 'at significant risk of carbon leakage'.⁷⁹ Member States are in charge of the auctions and receive all the proceeds. The linkage of the EU ETS with other cap-and-trade systems is allowed provided that the environmental objectives of the EU ETS are not undermined.

1. The recourse to JI/CDM credits and other international offsets by the covered sectors

a) In the absence of a global climate agreement

According to the ETS-Proposal JI/CDM credits from all types of project established before 2013 and accepted in the Community scheme during 2008 and 2012 may be exchanged for allowances of the third trading period up to the remainder of the level which they were allowed in the second trading period and may be used without restriction in the third trading period.⁸⁰ Furthermore, the Commission proposes to allow the use of 'external' credits resulting from projects started in least developed countries from 2013

⁷⁶ European Commission, COM (2008) 16.

⁷⁷ The two new gases are nitrous oxide and perfluorocarbons. Overall, these sectors represent nowadays about 60% of total greenhouse gas emissions in the EU. See European Commission, Memo 08/34, 23 January 2008.

⁷⁸ The Commission estimates that EU ETS sectors must contribute more than other sectors because it is cheaper to reduce emissions in the electricity sector than in most other sectors. See European Commission, Memo 08/34, 23 January 2008.

⁷⁹ This means that there is a threat that companies may relocate to third countries with less stringent climate protection laws.

⁸⁰ Whereas ERUs from JI projects may be taken into account for emission reductions until 2012, CERs may be taken into account with respect to emission reductions until 2012 but also from 2013 onwards. See Article 11a, par. 2 and 3 ETS-Proposal.

onwards.⁸¹ The justification for this privileged treatment is that these countries are ‘especially vulnerable to the effects of climate change and are responsible only for a very low level of greenhouse gas emissions’.⁸² Finally, in the event that the conclusion of an international agreement on climate change is delayed, operators are allowed to have recourse to credits from project activities in third countries with which the Community has concluded agreements.⁸³ However, once an international agreement on climate change has been reached, only CERs from third countries which have ratified that agreement shall be accepted in the Community scheme.⁸⁴

The reasons given by the Commission for allowing the exchange of CDM and JI credits is that it gives operators certainty that they may use them after the end of the second trading period. Clearly, the Commission also wants to avoid a price collapse similar to the one seen in the first trading period. This risk is all the more real, as the number of JI/CDM credits considerably exceeds the reduction required from operators with respect to their 2005 emissions.⁸⁵ Moreover, if the seven Member States which required the annulment of the Commission’s decision regarding their NAPs were to win their legal challenge, another significant quantity of allowances would flow into the EU ETS and diminish further the relative scarcity of allowances imposed by the Commission.

b) In the case of a global international climate agreement

The ETS-Proposal foresees that upon the conclusion of a future international agreement the ETS-Directive should provide for an automatic adjustment of the use of credits from JI/CDM credits and potentially additional types of credits and/or mechanisms envisaged under such an agreement. Operators may use up to half of the additional reduction taking place due to the international agreement CERs, ERUs or other types of credits earned in countries which have concluded the international agreement.⁸⁶ Once an international agreement on climate change has been reached, no CERs from third countries which have not ratified that agreement may be accepted as complying with the ETS.

⁸¹ These credits may be used until those countries have ratified an agreement with the Community or until 2020, whichever is the earlier. See Article 11, par. 4 ETS-Proposal.

⁸² This entitlement applies to all least developed countries until 2020 ‘provided that they have by then either ratified a global agreement on climate change or a bilateral or multilateral agreement with the Community.’ See Art. 11a par. 4 ETS-Proposal.

⁸³ See Article 11a par. 5 ETS-Proposal. The agreements concluded by the Community have to provide for the use of credits in the Community scheme from renewable energy or energy efficiency technologies which promote technological transfer and sustainable development. Any such agreement may also provide for the use of credits from projects where the baseline used is below the level of free allocation under the measures referred to in Article 10a of the ETS-Proposal or below the levels required by Community legislation. See Article 11a par. 6 ETS-Proposal.

⁸⁴ See Art. 11a par. 7 ETS-Proposal.

⁸⁵ See The World Bank (2008: 9).

⁸⁶ See Article 28 par. 3 ETS-Proposal.

C. The draft report of the European Parliament on the ETS-Proposal

The European Parliament entrusted the compilation of the first draft report on the ETS-Proposal to an Irish rapporteur of the Conservative Party, Mrs Avril Doyle, who published it in June 2008.⁸⁷ Simultaneously, Satu Hassi, the Finnish rapporteur of the Green Party, finalised her draft report on the Effort-Sharing Proposal.⁸⁸ The vote on both reports by the Environmental Committee of the European Parliament is scheduled for 7 October 2008.⁸⁹

In line with the Commission the ‘Doyle Report’ endorses the strategy of the European Council with respect to the overall emission reduction targets, i.e. a reduction of greenhouse gas emissions of 20% or 30% with respect to 1990 levels in the case of the conclusion of an international agreement on climate change.⁹⁰ In contrast to the ETS-Proposal, the report suggests that an increase of the reduction commitment would occur only after the ratification of a global international agreement and not as soon as it is concluded.⁹¹

Regarding the use of international offsets the report stipulates that operators should be allowed to use ‘external’ credits up to an average of 5% of their emissions during the period from 2013 to 2020, provided they use less credits from CDM and JI projects during the 2008-2012 period than the equivalent of 6,5% of their 2005 emissions and that they do not carry over entitlements from that period. In other words, operators under the ETS have the choice to either use ‘external’ credits at a level of 5% of their annual greenhouse gas emissions⁹² or to bank the credits they had been granted in the second trading period. According to the Doyle Report, this option enables operators to use ‘external’ credits for almost half of their abatement effort between 2013 and 2020 and would ensure that in the period 2008–2020, operators effectively reduce emissions below those for 2005.

⁸⁷ European Parliament (2008). Draft report on the proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend greenhouse gas emission allowance trading system of the Community, rapporteur Avril Doyle, (COM(2008)0016 – C6-0043/2008 – 2008/0013(COD)) – ‘Doyle Report’.

⁸⁸ See European Parliament (2008). Draft report on the effort of Member States to reduce their greenhouse gas emissions to meet the Community’s greenhouse gas emission reduction commitments up to 2020, Rapporteur Satu Hassi, (COM(2008)0017 – C6-0041/2008 – 2008/0014(COD)) – ‘Hassi Report’.

⁸⁹ The opinion of the European Parliament is prepared by a rapporteur, who issues a draft report and a draft legislative resolution, which is discussed and amended within the relevant parliamentary committee, then debated in a plenary session, where it is adopted by a simple majority. The parliamentary committee meets several times to study the draft report prepared by the rapporteur. The rapporteur and the members of both the parliamentary committee responsible and any other European Parliament committee may propose amendments to the Commission’s proposal. These amendments, together with those proposed by the parliamentary committees asked for an opinion, are put to the vote in the parliamentary committee responsible. Once the report is adopted in the parliamentary committee, it is placed on the agenda of the plenary session and put to the plenary’s vote. See http://ec.europa.eu/codecision/stepbystep/text/index_en.htm

⁹⁰ For instance, a 20% reduction effort by 2020 compared to 1990, which would be raised to 30% in the case of an international agreement on climate change.

⁹¹ Amendment to Article 11a par. 7 ETS-Proposal. See ‘Doyle’ report, cited above.

⁹² This possibility is subject to the above mentioned condition.

Unlike the Commission's proposal, the report also addresses the growing criticism levelled against the Kyoto Protocol project mechanisms by requiring additional qualitative guarantees with respect to the environmental integrity of international offsets.⁹³ Accordingly, the rapporteur proposes to accept exclusively JI/CDM credits and/or other 'external' credits provided for by a global climate accord if they come from so-called Gold Standard-type projects.⁹⁴ Where bilateral agreements with third countries are concluded, the report further specifies that credits envisaged by these agreements may also come from sustainable forestry activities in developing countries.⁹⁵ Finally, the rapporteur suggests that operators may use credits up to a non-specified percentage of their emissions from sustainable actions to reduce deforestation and increase afforestation and reforestation in developing countries, once appropriate provisions on liability, discounting and permanence have been laid down, which are also accepted by a US federal emissions trading system.⁹⁶

Through the simple reference to Gold Standard-type projects, the report deliberately leaves open the exact definition of such projects. To shed some light on its potential meaning it might be useful to recall briefly the aims of the Gold Standard⁹⁷ organisation and the requirements it sets out for CDM projects. The Gold Standard is a private foundation supported by NGOs, which was created 'to ensure that carbon markets work for a long term climate solution and that they stimulate local sustainable development'. Applying the standard CDM procedure,⁹⁸ the organisation does not itself judge or verify emission reductions, but sets out additional requirements with which a CDM project has to comply if a proponent wants to obtain the Gold Standard label for its project. Its main features are the restriction of eligible projects, the requirement for a sustainability assessment and the stipulation of stricter criteria for the stakeholder consultation process. They will be briefly explained below.

⁹³ The mechanisms are indeed increasingly criticised by experts and academics for their focus on unsustainable projects incapable of reducing the dependence of developing countries on fossil fuels, their inability to guarantee additional emission reductions and their potential for generating perverse policy incentives. See Wara (2008), Wara et al. (2008), Lohmann (2008), Schneider (2007), Michaelowa (2007), Pearson (2006).

⁹⁴ Amendments to Recitals 22, 25, Art. 11a par. 2, 3, 4, 7 of the ETS-Proposal. See Doyle Report, cited above.

⁹⁵ See Amendment to Article 11a par. 6 of the ETS-Proposal. See Doyle Report, cited above.

⁹⁶ Amendment to Article 28 – paragraph 4 – subparagraph 1 a (new) of the ETS-Proposal. See Doyle Report, cited above. For a discussion on the inclusion of forest activities by the future climate regime see in particular Helme et al. (2008: 103 ff.)

⁹⁷ See cdmgoldstandard.org.

⁹⁸ See UNFCCC (2005). Decision adopted by the Conference of the Parties serving as the meeting of the Parties to the Kyoto Protocol 30 March 2006, 3/CMP.1 Modalities and procedures for a clean development mechanism as defined in Article 12 of the Kyoto Protocol, FCCC/KP/CMP/2005/8/Add.1.

Unlike the CDM rules, which admit nearly all types of projects,⁹⁹ only renewables and end-use energy efficiency projects are eligible under the Gold Standard.¹⁰⁰ The reason advanced for this restriction is that these projects ‘reduce emissions at the source’ and hence contribute to reducing the dependence of developing countries on fossil fuels. As under the CDM rules, projects must lead to real, verifiable reductions in greenhouse gas emission and contribute to the sustainable development of a country hosting a CDM project. The definition of ‘sustainability’ is, contrary to a normal CDM project, not left to the country hosting a CDM project, but set out in detail by two tools of the organisation, the ‘Gold Standard Requirements’ and the ‘Gold Standard Toolkit’. According to the latter project proponents are asked to assess the risk that their project activities will have severe negative environmental, social and/or economic impacts, and must demonstrate that their project activities have clear sustainable development benefits through a detailed impact assessment. Hence a project has to be scored on environmental, social and technological and economic indicators.¹⁰¹ To allow for a detailed score to be given, twelve specific environmental, social and economic indicators have to be considered, which together with the scoring form the sustainable development matrix. Furthermore, a sustainability monitoring plan has to be set up to assist in verifying the impact of the project on the sustainable development of the host country.¹⁰² Finally, the ‘Stakeholder Consultation Guidelines’ set out by the Gold Standard must be respected; these lay down strict criteria for the involvement and information of local stakeholders, in particular NGOs supporting the Gold Standard.

By requiring that credits come from Gold Standard-type projects, the Doyle Report ensures that the Gold Standard is not entrusted a monopoly position with regard to the certification of ‘external’ credits allowed into the ETS. The question as to which criteria will have to be fulfilled and who is responsible for formalising and controlling them must thus still be answered..

D. Evaluation of the ETS-Proposal and the draft Doyle Report

The Commission’s ETS-Proposal addresses many of the issues highlighted for reform during the review process, including the call for an overall EU cap and a global limit on

⁹⁹ A notable exception is nuclear power. The ‘Bonn Agreements’ stipulate in particular that developed parties ‘have to refrain’ from using nuclear power for CDM projects. See UNFCCC (2001). Review of the implementation of commitments and of other provisions of the convention. Preparations for the first session of the conference of the parties serving as the meeting of the parties to the Kyoto Protocol (Decision 8/CP.4). Decision 5/CP.6, Implementation of the Buenos Aires Plan of Action’, FCCC/CP/2001/L.7, 24 July.

¹⁰⁰ ‘Renewable energy projects’ are defined as the generation and delivery of energy services (e.g. mechanical work, electricity, heat) from non-fossil and non-depletable (landfill gas excluded) energy sources. ‘End-use energy efficiency’ projects are defined as activities that reduce the amount of energy required for delivering or producing non-energy physical goods or services. See Paragraph III.d.2 and 3 of the ‘The Gold Standard Premium Quality Carbon Credits Requirements’ (The ‘Gold Standard Requirements’) published at: http://www.ecofys.com/com/publications/documents/GSV2_Requirements_20080731_2.0.pdf

¹⁰¹ See Annex I of the ‘Gold Standard Toolkit’.

¹⁰² See Paragraph VII.a of the ‘Gold Standard Requirements’.

the use of JI/CDM credits in the third trading period. It thus puts an end to the legal uncertainty created by the reference to the ‘supplementary criterion’ set out by the Marrakesh Accords and the free-riding of certain Member States. Furthermore, by allowing EUAs and CERs to be banked, the ETS-Proposal helps to prevent the potential ‘overallocation’ in the second trading period leading to a complete price collapse of the EUA and the demand for carbon credits in the international carbon market dying down as the end of the first commitment period of the Kyoto Protocol approaches.¹⁰³

Notwithstanding these improvements, the Commission’s proposal has been strongly criticised by NGOs¹⁰⁴ and academics¹⁰⁵ alike for its lack of environmental ambition, the overemphasis on international offsets and the absence of any qualitative criteria ensuring their environmental quality in the case of a global climate agreement.

1. The lack of environmental ambition

The emission reductions, both in the case of the 20% and the 30% reduction scenario, are well below the recommendations of the IPCC regarding the action to be taken by industrialised countries to stabilise global warming at about 2 degrees Celsius above pre-industrial levels.¹⁰⁶ Höhne, for instance, indicates that, to reach this target, industrialised countries would have to reduce their emissions to between 25% and 40% below 1990 levels by 2020 whereas developing countries would have to keep emissions between 15% and 30% below baseline.¹⁰⁷ He concludes thus that an EU target compatible with limiting climate change to 2 degrees Celsius would require reductions of emissions within the EU to at least 30% below 1990 levels plus support for developing countries through CDM or another carbon mechanism of the order of magnitude of an additional 10 percentage points.¹⁰⁸

The necessity for taking stronger action is, in particular, recognised by the Hassi Report on Effort-Sharing. Recalling that the European Parliament had itself called in October 2006 for a 30% reduction target, the rapporteur proposes to turn ‘upside down’ the Commission’s proposal by using the reduction target of 30%¹ as a starting point and keeping the 20% reduction as a fallback option in the case that no international agreement on climate change is concluded.¹⁰⁹ Hassi finally advocates that the recourse to credits

¹⁰³ Many stakeholders in the international carbon market, such as the World Bank, were however disappointed by the Commission’s Proposal insofar as the use of CERs is so far limited to the use of credits from projects initiated before 2012 or of projects from least developed countries. See The World Bank (2008: 34).

¹⁰⁴ WWF (2008), Greenpeace (2008), CAN (2008).

¹⁰⁵ Höhne (2008), Schneider (2008).

¹⁰⁶ IPCC (2007), Barker (2008).

¹⁰⁷ Höhne (2008).

¹⁰⁸ Höhne (2008: 2).

¹⁰⁹ Hassi justifies this choice on the basis that the 20% target is far too low if the EU wants to make an equitable contribution towards keeping the increase in global warming below 2 degrees Celsius.¹⁰⁹ She contends further that it is easier for Member States to ‘direct the planning and implementation measures’ from scratch with regard to a 30% reduction target, which may, in the case of unsuccessful international negotiations be easily downgraded, whereas it is much more difficult to tighten the reduction effort once an

resulting from projects in third countries should, as a rule, not replace the domestic reduction effort but reflect an additional commitment taken by industrialised countries to assist developing countries. She proposes instead that the EU endorses a so-called additional ‘external’ commitment, which, in the case of the conclusion of a global climate accord, would mandate the EU to assist developing countries in their activities to mitigate climate change.¹¹⁰

2. The emphasis placed on international offsets

The important recourse to international offsets by covered sectors, which is contemplated by both the ETS-Proposal and the Doyle Report, is expected to reduce significantly the potential carbon price within the EU ETS.¹¹¹ According to Hassi this necessarily entails that innovation within the EU, which reduces its own dependence on fossil fuels, will be slowed down considerably.¹¹² With regard to the power industry, which is responsible for 24% of the European Union’s greenhouse gas emissions,¹¹³ this means in particular that the expected EUA price will be insufficient by itself to trigger a massive switch to renewable energies or to enable the development and large-scale deployment of CCS for fossil-fuel power stations in the next decades.¹¹⁴ Given that most existing large electricity plants will have to be replaced in the next 10–20 years and that fossil-fuelled power stations have a life-time of approximately 40 years,¹¹⁵ many analysts hence expect that in the absence of decisive action supporting the deployment of renewable energies¹¹⁶ and/or nuclear energy in the recently liberalised power industry, the European power industry will be locked into a fuel mix with a high share of fossil fuels¹¹⁷ for many decades to come.

The significant recourse to international offsets envisaged by the ETS-Proposal is indeed likely to prevent the expected EUA price from increasing sufficiently to ensure a rapid

international climate agreement has been concluded. See European Parliament (2008), draft Hassi Report, cited above.

¹¹⁰ See European Parliament (2008), draft Hassi Report, cited above.

¹¹¹ See for an analysis of the expected EUA price in the various scenarios European Commission (2008), Commission Staff Working Document SEC (2008) 85/3, Impact Assessment, Document accompanying the Package of Implementation measures for the EU’s objectives on climate change and renewable energy for 2020.

¹¹² See European Parliament (2008), draft Hassi Report, cited above.

¹¹³ See IEA (2006: 171).

¹¹⁴ According to Dieter Helm the most likely outcome of the Commission’s ETS-Proposal on the power sector is a large-scale dash-for-gas, the use of more coal and eventually the renewed construction of nuclear power plants. See Helm (2008: 12).

¹¹⁵ See for more information on the investment conditions in the recently liberalised European power market de Sépibus (2008: 37).

¹¹⁶ See for more details on the necessary investments in the power infrastructure in the case of a large deployment of renewable energies de Sépibus (2008: 32).

¹¹⁷ In 2004, conventional thermal energy fuelled by coal, gas and oil emitted most of them, with a share of almost 54% for electricity production. Coal and lignite accounted for 29.5%, gas for 20% and oil for 4.5%. The second-largest source was nuclear energy, which generated 31%, i.e. almost a third of the EU’s electricity. Together, these sources contributed about 85% of the total production, leaving the remainder for renewable electricity production. See EEA (2007).

decarbonisation of the power industry as called for by Al Gore¹¹⁸ to meet the recommendations of the IPCC.¹¹⁹ It is interesting to note that the Commission once again has recourse to a 50% ceiling for 'external' credits, which echoes the limit initially proposed for the 'Linking Directive' and the ceiling established in its decision in 2006 for the second trading period.¹²⁰ Unlike the latter decision the new 50% ceiling does not provide for exceptions in favour of the 'new' Member States and is exclusively applicable to the covered sectors of the ETS in the case of the conclusion of a new global climate accord.

3. The absence of qualitative criteria for international offsets

The criticism regarding the absence of qualitative requirements regarding the use of international offsets from the ETS-Proposal is rooted in the growing concern about the environmental effectiveness of the CDM mechanism.¹²¹ Its proponents upheld that through this choice the EU is missing an important opportunity to send a clear signal to the stakeholders of the international carbon market that the EU is no longer willing to back projects which do not lead to real and measurable emission reductions and support sustainable development.¹²²

Against this argument it may be objected that the decision of the Commission to refrain from requiring qualitative criteria with respect to Kyoto 'units' is inherent to its choice to allow banking of EUAs from the second to the third trading period. Indeed, any restriction of eligible offsets in the third trading period could easily be eluded by the covered sectors through the swapping of CDM/JI credits for EUAs in the second trading period, which can then be banked. The positive effects of the additional qualitative requirements on the environmental integrity of the CDM projects would thus remain quite limited.

Regarding the criticism on the absence of qualitative criteria for 'external' credits in the case of the conclusion of an international climate agreement, the Commission replied that its proposal does not preclude any decision of the EU to require stricter criteria within the framework of the future climate accord.¹²³ Moreover, by keeping all options open the EU is ensured more leverage during the international negotiation process and greater room for manoeuvre to craft new innovative instruments.

¹¹⁸ In his speech of 17 July 2008, Al Gore called for US power to be fuelled by 100 % from renewable energy sources in ten years. See http://www.wecansolveit.org/pages/al_gore_a_generational_challenge_to_repower_america/

¹¹⁹ According to the IPCC report the CO₂ emissions of industrialised countries must be reduced between 50% and 85% to ensure the highest probability of stabilising the global temperature increase between 2 and 2.4 degrees Celsius above pre-industrial levels. See IPCC (2007: 15).

¹²⁰ European Commission, COM (2006) 725.

¹²¹ Wara (2008), Wara et al. (2008), Lohmann (2008), Schneider (2007), Michaelowa (2007), Pearson (2006).

¹²² Greenpeace (2008), WWF (2008), See European Parliament (2008). draft Hassi Report, cited above.

¹²³ Oral response of the Commission staff member Jürgen Salay at the hearing of the European Parliament on the Hassi Report in June 2008. See also Salay (2008).

While these arguments are at first sight appealing, the lack of a clear position of the EU on the environmental integrity of ‘external’ credits has its drawbacks. Indeed, the EU partly forfeits its reputation as a leader in the climate change debate and runs the risk of continuing to finance the ‘false’ emission reductions of projects that do not foster sustainable development. The proposal of the Doyle Report, restricting the use of ‘external’ credits to Gold Standard-type credits, represents, in this respect, a good compromise.¹²⁴ Even if the proposal remains unsatisfactory in terms of the clarity of its wording, it offers a good starting point for a stricter policy regarding the use of international offsets in a situation where lessons from the international carbon market have still to be learnt.

The reference to the Gold Standard is pertinent, as the requirements of this label, supported by numerous NGOs, do indeed represent an innovative and yet pragmatic way to ensure better environmental quality of greenhouse gas emission offsets. The Gold Standard, however, does not address all criticisms levelled against the CDM mechanism. For instance, the verification of the Gold Standard Requirements is done by the same private entities which are criticised for their insufficient neutrality and sometimes dubious professionalism.¹²⁵ Also, there is a lack of control of the work of the Gold Standard organisation by democratic institutions. Finally, a restriction of the CDM mechanisms to renewable energy and end-use energy projects presents, besides the obvious advantages of this kind of projects in limiting the dependence on fossil fuels, also has disadvantages. First, it reduces the scope of this mechanism to discover and address cheap mitigation options and impairs the stability of the international carbon market.¹²⁶ Second, the ‘additionality’¹²⁷ of renewable energy and end-use efficiency projects is often doubtful and subject to gaming.¹²⁸ Third, many experts suggest that the offset mechanism does not represent an appropriate instrument to encourage this type of project and that they would be better supported by other instruments such as investment subsidies and/or technical assistance.¹²⁹

Hence, a simple reference to the Gold Standard, as suggested by some NGOs¹³⁰ which would entrust this organisation with the control of the environmental quality of offsets allowed into the EU ETS, does not seem advisable at this stage. However, the procedural and material requirements set up by the Gold Standard could offer a good model for the constitution of a European ‘label’, which would not only set up a ‘positive’ list of admissible projects, but ensure its sustainability through the formulation of supplemental

¹²⁴ A similar proposal is made by Satu Hassi in her draft report on Effort-Sharing, where she argues for limiting the use of Kyoto ‘units’ and other international offsets to projects on renewable energies and energy efficiency and discounting the credits generated by 50%. See European Parliament (2008), draft Hassi Report, cited above.

¹²⁵ See for instance Wara et al. (2008), Schneider (2007).

¹²⁶ Hampton (2007 :10).

¹²⁷ The term ‘additionality’ in this context means that CDM project must lead to emission reductions which would not have occurred in the absence of the project.

¹²⁸ Michaelowa et al. (2008), Michaelowa (2007), Purohit et al. (2007), Michaelowa et al. (2007), Willis et al. (2006).

¹²⁹ See Driesen (2006), Willis et al. (2006).

¹³⁰ See WWF (2008).

requirements similar to those set out by the Gold Standard. Such a label, which could be revised from time to time to respond to evolving needs would of course not address all environmental shortcomings of the actual CDM label, but could, combined with a revision of the current CDM procedure, represent a concrete step towards improving the environmental quality of international offsets.

III. Conclusions

The debate on the criteria governing the linkage of the EU ETS with international offsets takes place against the backdrop of the international negotiations on a new global deal on climate change which is expected to be concluded in Copenhagen at the end of 2009. Its general boundaries are set by the unilateral commitment of the EU in 2007 to reduce its greenhouse gas emissions by 20% or by 30% and the Bali Action Plan adopted at the end of 2007, which makes any commitment of developing countries dependent on ‘a clearly identifiable support of developed countries, including technology transfer, financing and capacity-building’.¹³¹

The European view on the appropriateness of linking the EU ETS with the international project mechanisms has changed over the years as the discussion on the numerous interpretations of the ‘supplementarity’ criteria testifies. Whereas the Commission was initially sceptical as to an integration of Kyoto credits into the EU ETS, fearing lax international rules on CDM and JI,¹³² the position has changed due to the pressure from emitters. By the time the ‘Linking Directive’ was finally adopted, a general shift of attitudes had taken place as the absence of a clear limit for CDM and JI by this Directive attests. A major reason for this change of heart was that companies covered by the EU ETS had made clear that they would remain inflexible regarding the initial amount of EUAs allocated unless they could get access to the CDM.¹³³

The collapse of the EUA in 2006, however, somewhat dampened the enthusiasm generated by the successful kick-off of the international carbon market. Moreover, the IPCC stressed that industrialised countries had to step up their domestic reduction effort significantly to stabilise global warming.¹³⁴ Further, the analysis of a growing number of academics and observers of the CDM market shows that many CDM projects are not ‘additional’¹³⁵ and that the mechanism in its current form is unable to mobilise funds on the scale they are needed.¹³⁶ Especially in the United States, which is likely to take a

¹³¹ See Ott et al. (2008: 93). The claim of developing countries to receive funds and help from industrialised countries is based on the fact that they have emitted less greenhouse gases and thus have less responsibility for climate change than industrialised countries. Moreover, they are less able to finance emissions reductions. See table of per capita emissions in Neuhoff (2008: 60).

¹³² See Michaelowa (2004: 3).

¹³³ See Hægstad Flâm (2007), Michaelowa (2004: 4).

¹³⁴ IPCC (2007: 15).

¹³⁵ The term ‘additional’ means that the projects do not lead to real emissions reductions, which would have occurred in the absence of the project. See Schneider (2007), Wara (2008), Wara et al. (2008), Michaelowa (2007).

¹³⁶ Sterk (2007).

firmer grip on climate change after the presidential elections at the end of 2008 and where many states are preparing to set up emission trading schemes, the linking with 'external' credits is intensely debated. Whereas certain critics argue that the recourse to international offsets leads to large transfers of money in favour of China and India which are not matched by any significant emission reductions,¹³⁷ others are in favour of their use but call for strict procedural safeguards to ensure their environmental integrity.¹³⁸

In the European Union, the upcoming vote in October 2008 by the Environmental Committee of the European Parliament on the ETS- and Burden-Sharing proposals and later on the vote in the Council is mobilising thousands of stakeholders behind the scenes. The pressure to maintain the current system is important, as the considerable financial interests of both the covered industries of the EU ETS and the stakeholders of the international carbon markets are at stake.¹³⁹ Given the wide spectrum of views among the Member States and the European Parliament, the stage is no doubt set again for an intense tug-of-war.¹⁴⁰ It remains to be seen whether the final compromise on the linking issue will ultimately meet the common climate challenge.

¹³⁷ Wara et al. (2008).

¹³⁸ Offset Quality Initiative (2008).

¹³⁹ See for instance the report of The World Bank (2008).

¹⁴⁰ See, for instance, the harsh bargaining of negotiation process of the Linking-Directive Hægstad Flåm (2007).

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