

Briefing Note: LULUCF Amendment to the EU ETS

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1. Objective

The 9th session of the Conference of the Parties to the UNFCCC (December 2003) adopted the modalities and procedures for the inclusion of afforestation and reforestation (A/R) projects in the CDM. In the light of the application of these modalities, the Commission is to give due consideration to whether and, if so, how credits from land use, land-use change, and forestry (LULUCF) activities could be used in entity-level emissions trading in the EU Emission Trading Scheme (EU ETS). It is not the intention of this note to anticipate any political decision on the topic. However, if the EU law maker decides to allow the use of CERs from A/R project activities and ERUs from LULUCF project activities for compliance under the EU ETS, the note looks at how an amendment to Directive 2003/87/EC (as amended by Directive 2004/101/EC) could be drafted.

2. LULUCF Credits

LULUCF credits generated by CDM and JI project activities include tCERs, lCERs, and ERUs. Temporary CERs (tCERs) are titles that expire in the commitment period following their issuance. The same project activity can issue and transact tCERs several times, provided that the sequestration is verified again. Long-term CERs (lCERs) are titles that expire only at the end of the crediting period of the project provided that the sequestration level is verified every 5 years. Both tCERs and lCERs have to be replaced upon expiry. They can be replaced by AAUs, CERs, ERUs, RMUs or newly issued tCERs. ERUs from LULUCF show the same characteristics as ERUs linked to greenhouse gas mitigation activities. They do not need to be re-verified nor replaced. Their permanence will be assessed and accounted for in each national communication submitted to the UNFCCC secretariat.

RMUs issued on the basis of Article 3.3 of the Kyoto Protocol are not considered by the proposed amendment since they do not fall under the credits generated by CDM and JI and only those are currently covered by the EU ETS.

3. Scope of the Amendment

The proposed amendment intends to give LULUCF credits the same privileges as CERs and ERUs generated by mitigation projects, chiefly to be able to be used for compliance under the EU ETS. It is drafted to be flexible enough to accommodate further changes in the rules governing CDM and JI. However, the temporary nature of tCERs and lCERs requires particular consideration. Any temporary credit used for compliance in a registry account of a Member State results in a government liability. The liability is created by the need to replace the temporary credit. Countries authorizing the use of temporary credits can pass this liability on to the operators using LULUCF credits for compliance or devise government-managed mechanisms to hedge the liability created through the acceptance of LULUCF credits.

4. Explanation of the Proposed Amendment

The proposed amendment addresses the following issues:

- It expands the scope of the Community scheme to authorize Member States to allow LULUCF credits for compliance use. The decision to authorize the use of LULUCF credits remains with the Member States. There is no such decision on the EU level.

- It allows for the quantitative limitation on the use of tCERs and lCERs for compliance with the Kyoto Protocol to be dealt with in the national allocation plans. It is suggested to provide for this limitation in the national allocation plan rather than in the directive as it gives Member States greater flexibility to determine how many LULUCF credits can be used under the EU ETS. This approach is consistent with how each Member State is to determine how best to respect the principle of supplementarity, which is dealt with in the national climate strategies of the member states.
- It allows each Member State respond to concerns raised over the possible misuse of genetically modified organisms and potentially invasive species in afforestation and reforestation project activities. The approach reflects the approach taken by the COP/MOP in Decision 19/CP.9 and is consistent with the approach previously taken to addressing concerns over hydroelectric projects.
- Credits generated by JI activities (ERUs) can be included into the system of the EU ETS in the same manner as CERs and ERUs from mitigation activities have been linked to the EU ETS by the Linking Directive. In the case of JI activities, the country is ultimately reliable for its AAU balance and any loss in biomass of a JI activity is backed by an Annex I AAU. Credits from LULUCF JI activities are therefore not temporary in nature. The scope of projects is also not limited to A/F activities.
- Authorizing the use of LULUCF credits from CDM project activities is more complex since the system needs to address the temporary nature of those credits and the resulting replacement obligation. This paper contemplates two different options as to how *temporary credits* can be included into the compliance system of the EU ETS.
- Amendment option 1 transfers the replacement obligation to the operators using tCERs or lCERs for compliance.
 - The obligation to replace a tCER or lCER 30 days before the expiration of the tCER or lCER was chosen as the CDM Executive Board will notify the Member State holding a tCER or lCER of the need to replace the tCER or lCER one month before they are due to expire.
 - The obligation to replace an lCER within 15 days of being notified by the Executive Board of the need to replace the lCER was chosen as a Member State will have 30 days to replace the lCER once it has been notified of the need to replace it. If an operator fails to replace the lCER within 15 days, the Member State will still have 15 days to make alternate arrangements for its replacement.
 - If any particular operator fails to replace the tCERs or lCERs it uses, it will be liable to pay an emission excess penalty.
- In amendment option 2 the Member State remains liable for replacing expired or ineligible tCERs or lCERs. The Member State manages this liability by applying an exchange rate when issuing allowances for tCERs, lCERs which reflects the replacement risk.
- Amendments to paragraphs 2, 3, and 4 of Article 11b that deal with double counting are not necessary. Credits issued for a LULUCF activity will not lead to direct or indirect double counting problems under the EU ETS since LULUCF project activities do not receive any allowances (direct double counting) nor do they lead to the freeing up of allowances in the EU ETS (indirect double counting).

5. Two Proposals to Amend the EU ETS to allow the use of LULUCF credits

Two different amendments to Directive 2003/87/EC (as amended by Directive 2004/101/EC) are proposed to enable the use of LULUCF credits in the EU ETS. The first amendment holds the operator liable for the replacement of *temporary* LULUCF (tCERs, ICERs) credits. In the second amendment, the Member State that allows the use of tCERs and ICERs remains liable for replacing the tCERs and ICERs. In order to further simplify the amendment, Member States may consider limiting the amendment to tCERs. Since these credits do not fall under the requirement of continuous monitoring and verification, the resulting replacement liabilities are slightly more cost efficient to monitor and manage. This is because all tCERs will expire on the same date so Member States will know ahead of time exactly what replacement obligations will arise. This is different to ICERs where the replacement obligation for ICERs from different projects will occur at different times, and may arise with only one month notice.

General amendment applicable to both proposals

Directive 2003/87/EC is hereby amended as follows:

In Article 3 (Definitions), the following points should be added:

(o) “temporary certified emission reduction” or “tCER” means a unit issued from afforestation or reforestation project activities and will expire at the end of the commitment period following the one during which it was issued pursuant to Article 12 of the Kyoto Protocol and the decisions adopted pursuant to the UNFCCC or the Kyoto Protocol.

(p) “long-term certified emission reduction” or “ICER” means a unit issued from afforestation or reforestation project activities and will expire at the end of the crediting period of the afforestation or reforestation project activity for which it was issued pursuant to Article 12 of the Kyoto Protocol and the decisions adopted pursuant to the UNFCCC or the Kyoto Protocol.

We suggest replacing Article 11(a)(3) by the following:

All CERs and ERUs that are issued and may be used in accordance with the UNFCCC and the Kyoto Protocol and subsequent decisions adopted thereunder may be used in the Community scheme except that, in recognition of the fact that, in accordance with the UNFCCC and the Kyoto Protocol and subsequent decisions adopted thereunder, Member States are to refrain from using CERs and ERUs generated from nuclear facilities to meet their commitments pursuant to Article 3(1) of the Kyoto Protocol and in accordance with Decision 2002/358/EC, operators are to refrain from using CERs and ERUs generated from such facilities in the Community scheme during the period referred to in Article 11(1) and the first five-year period referred to in Article 11(2). **(11(a)3.(b) deleted)**

And adding a new Article 11(a)(4):

Member States may allow the use of tCERs [*and ICERs*] from project activities in the Community scheme up to a percentage of the national allocation, to be specified by each Member State in its national allocation plan for that period.

In the case of afforestation and reforestation project activities, Member States shall, when approving such project activities ensure that project activities involving genetically modified organisms or potentially invasive species have [evaluated] [taken into account] [given appropriate consideration to] the impacts of such projects on biodiversity and natural ecosystems.

First proposal: The operator is liable for replacement

In this case we suggest the following additions to 11(a)(4). The proposed language covers both the inclusion and exclusion of ICERs.

An operator that has used a tCER shall surrender a CER, tCER, ERU, or allowance at least 30 days before the tCER expires to cover the emissions which had been covered by the expired tCER. If the operator has not replaced any tCERs it has used to cover its emissions by the time it expires, the operator shall be held liable for the payment of the excess emissions penalty in accordance with Article 16.

[An operator that has used an ICER shall surrender a CER, ICER from the same project activity, ERU, or allowance at least 30 days before the ICER expires to cover the emissions which had been covered by the expired ICER. If the operator has not replaced any ICERs it has used to cover its emissions by the time it expires, the operator shall be held liable for the payment of the excess emissions penalty in accordance with Article 16.]

An operator that has used an ICER which has been rendered ineligible pursuant to the UNFCCC or the Kyoto Protocol shall surrender a CER, ICER from the same project activity, ERU, or allowance within [15] days of being notified by the Member State holding the ICER that the Executive Board has determined that the ICER needs to be replaced. If the operator does not replace the ineligible ICER within [15] days of being declared ineligible, the operator shall be held liable for the payment of the excess emissions penalty in accordance with Article 16.]

And consequently, we suggest adding in Article 16 the following point:

4. Member States shall ensure that any operator who does not replace a tCER or ICER in accordance with this Directive shall be held liable for the payment of an excess emissions penalty. The excess emissions penalty shall be EUR 100 for each expired or cancelled tCER [or ICER] used by the operator that has not been replaced by that operator in accordance with this Directive. Payment of the excess emissions penalty shall not release the operator from the obligation to surrender an amount of allowances equal to those excess emissions when surrendering allowances in relation to the following calendar year.

Second proposal: The State remains liable for replacement

In this case we suggest Article 11(a)(1) could be replaced by the following, which covers both the inclusion and exclusion of ICERs:

Subject to paragraph 3, during each period referred to in Article 11(2), Member States may allow operators to use CERs and ERUs from project activities in the Community scheme up to a percentage of the allocation of allowances to each installation, to be specified by each Member State in its national allocation plan for that period (**unchanged**). The use of CERs (other than tCERs[and ICERs]) and ERUs shall take place through the issue and immediate surrender of one allowance by the Member State in exchange for one CER or ERU held by the operator in the national registry of its Member State. For tCERs the use shall take place through the issue and immediate surrender of [Y] allowances by the Member State in exchange for [X] tCERs held by the operator in the national registry of its Member State. [ICERs shall not be eligible for use.][For ICERs the use shall take place through the issue and immediate surrender of [Z] allowances by the Member State in exchange for [X] ICERs held by the operator in the national registry of its Member State.]