



CLIMATE FOCUS

January 2008

Climate Focus: Carbon Market Background Paper

Trading Secondary CERs from Hydropower Projects above 20MW

Summary

This memorandum examines issues that have arisen regarding EU Member State recognition of Certified Emissions Reductions (CERs) from hydropower projects above 20MW (“Hydro CERs”).

The analysis carried out in this memorandum is two-fold. First, it examines the issue of if Hydro CERs, at present, are mutually recognized and thus freely tradable (fungible) on the European Union Emissions Trading Scheme (EU ETS) secondary market. Then, it analyses the issue of if and how a Member State could impose restrictions on Hydro CERs generated by a hydro project that another Member State has approved.

This memorandum concludes that currently Hydro CERs are fungible. This conclusion is based on the Linking Directive’s plain language, which only sets forth criteria for the approval of hydro projects, not the approval and transfer of Hydro CERs from such projects. As this memorandum demonstrates, even if a Member State would seek to impose restrictions on Hydro CERs that another Member State has approved, it is unlikely that the imposing of such restrictions would be allowable under EU Law.

1 Introduction and Background

Social and environmental impacts of large hydropower projects have long been a concern of many environmentalists. More recently such concern has also been weighed in the context of implementing the international climate change regime. On one side it is acknowledged that hydropower is an attractive energy source with high potential, relatively low operational cost and significant GHG emissions reduction potential. Yet, hydro plants may also cause significant social and environmental disruption if not properly implemented and monitored.

Large hydropower projects are eligible to create emission reduction credits known as CERs under the Kyoto Protocol’s Clean Development Mechanism (“CDM”). Conscious of criticism toward hydroelectric projects, the EU has attempted to regulate the use of CERs



CLIMATE FOCUS

and Emission Reduction Units (“ERUs”) from large hydro projects under the EU ETS. The present analysis attempts to address recent issues that have arisen regarding EU Member States’ potential limitations on recognizing CERs generated from hydropower projects above 20MW and the impact of this upon the transferability and tradability of such Hydro CERs, taking into account the applicable EU legislation and existing international guidelines for the development of hydropower projects.

2 Are Hydro CERs Mutually Recognized and Freely Tradable at this Time?

The Directive 2003/87/EC establishes the main rules and procedures of the EU ETS.¹ This Directive was later amended by Directive 2004/101/EC (the so-called “Linking Directive”).² The Linking Directive regulates the use of project-based credits from the Kyoto Protocol within the Community scheme and introduces conditions for the use of CERs and ERUs for compliance under the EU ETS.

Article 11a(6) of the Linking Directive allows the use of credits from hydroelectric projects with a capacity of less than 20MW, but imposes additional qualitative restrictions on approval of hydro projects with a capacity of more than 20MW for the generation of CERs. The Linking Directive states:

In the case of hydroelectric power production project activities with a generating capacity exceeding 20 MW, Member States shall, when approving such project activities, ensure that relevant international criteria and guidelines, including those contained in the World Commission on Dams November 2000 Report ‘Dams and Development — A New Framework for Decision-Making’, will be respected during the development of such project activities.³

The Linking Directive, therefore, does not exclude the use of CERs from large hydro projects, but only shifts the responsibility for verifying the quality of certain projects (and thus of the credits originated by such projects) to the Member States. In this

¹ Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a Scheme for Greenhouse Gas Emission Allowance Trading within the Community and Amending Council Directive 96/61, OJ 2003 L275 .

² 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, OJ L338 13.11.2004, p. 18–23 (hereinafter “Linking Directive”).

³ The Linking Directive also introduces the obligation to include in the ETS revision process, set forth under Article 30 of Directive 2003/87, an evaluation of approved CDM hydro projects with generating capacity above 500MW and of the future use of CERs resulting from any such projects in the Community scheme. See article 1.8(b) of the Linking Directive



CLIMATE FOCUS

respect, it merely confers EU individual countries the duty to ensure that all hydropower plants above 20MW, regardless of type (dammed or run-of-river), follow widely endorsed standards, including those of the World Commission on Dams (“WCD”), to prevent negative impacts. Nothing in the language of the Linking Directive provides a Member State with direct authority to create its own unique restrictions on CERs generated from such projects once the project has received approval. That a Member State would undertake to create its own distinctions regarding Hydro CERs would also conflict the underlying goals of an EU wide market where allowances may be traded without unique Member State imposed restrictions. This goal is clearly set forth in the Commission’s guidance upon proposal of the Linking Directive. The guidance states:

The Community scheme creates an EU wide market where allowances can be traded without restriction, meaning that Member States cannot take individual decisions on what credits to recognize or not to recognize. It is therefore necessary to take a common approach to project activities in the context of the Community scheme.⁴

This shows that the Commission intended to avoid any restrictions that would impact the fungible nature of the credits allowed for under the Linking Directive.

It is also clear under the language of the Linking Directive that it does not require any additional approval by an acquiring Member State after the “importing” EU Member State has formally approved a particular hydro project. Once the CER has been imported in this way it can be freely traded within the community registries⁵ and then used under the EU ETS. The fungible nature of CERs from hydro projects above 20MW is thus not affected by any dissimilar approval requirements of the Member States and any CERs approved by an EU Member State can be used by installations to meet their EU ETS obligations. Once a hydro project above 20 MW has obtained a Letter of Approval by a Member State in the ETS the respective CERs eventually issued will have full recognition and unrestricted circulation among national registries in the EU.⁶ Accordingly, Hydro CERs are mutually recognized and freely tradable among Member States at this time.

⁴ See Proposal 2003/0173.

⁵ See Regulation 2216/2004 for a standardised and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision 280/2004/EC of the European Parliament and of the Council (hereinafter “Registry Regulation”).

⁶ Subject, of course, to the quantitative restrictions on the use of CERs as established by the member states in their national allocation plans and the eligibility requirements of countries to participate in international emissions trading.



CLIMATE FOCUS

3 Could a Member State Exclude or Limit the Use of Hydro CERs?

To date no Member state has imposed restrictions upon the transferability or use of Hydro CERs from large hydro projects approved by other Member States. Before examining the issue of if and how a Member State could impose restrictions on such Hydro CERs, from large hydro projects approved by other Member States, it is necessary to first take a step back and examine the WCD Guidelines and other such international guidelines on dams as referenced in the Linking Directive and which give rise to the current confusion on this issue.

The WCD Guidelines

The 2000 WCD's guidelines do not establish a framework to test the quality of existing hydropower projects.⁷ Instead, they are intended to set forth strategic priorities and principles to guide the decision-making process in the development of large dams. The WCD guidelines are not an international legal document; however, through the inclusion made by the Linking Directive, the WCD guidelines have acquired legal significance at the EU and Member State level.⁸

The ETS Linking Directive makes no distinction between types of hydro plants. It merely defines a threshold (set in accordance with plant's generation capacity) above which the WCD's guidelines have to be observed.⁹ The WCD's guidelines also do not distinguish between types of hydro plants (dammed and run-of-river plants) for the purposes of defining large dams. The conclusion that can be drawn from this is that the WCD's criteria and guidelines must be respected whenever a hydropower project exceeds 20MW of generation capacity, regardless of the type of the project (run-of-river or not). Consequently, any decision of only prohibiting the trade of CERs from hydro projects above 20MW which are not described as run-of-river has no basis under EU legislation.

Member State's discretion in the application of the WCD Guidelines

Given that the Linking Directive refers to the WCD guidelines in a very general manner and that the European Commission has not (yet) issued any guidance on the

⁷ See report available at <http://www.dams.org/>.

⁸ While not exactly the same as building codes or regulations, certain analogies to this type of legal instrument can be drawn as the WCD can be seen to be a type of "industry standard" for large hydro.

⁹ It should be noted however, the WCD recommends the application of its criteria to all large dams, defined as any hydro plant whose dam is over 15 meters high or between 5 and 15M with a reservoir volume of more than 3 million cubic meters and does set a specific generating-capacity threshold for applicability such as that set forth under the EU ETS.



CLIMATE FOCUS

interpretation of the WCD guidelines, it is up to the Member States to decide how to interpret the WCD or other relevant guidelines. Thus a wide margin of discretion to interpret such guidelines is left to Member States and transposition of the ETS Directive on this point can vary considerably.

Divergence in the Member States' approval procedures for hydropower projects above 20MW is thus a logical consequence of the general reference to the WCD report and the lack of specific EU standards being formulated for the evaluation of hydropower projects.

Restrictions on Hydro CERs in the Transposition of the Linking Directive

Because the Linking Directive does not provide for limitations or excluding of Hydro CERs, a Member State could argue that it needs to go beyond the requirements of the Linking Directive by establishing measures limiting or excluding the use of Hydro CERs (or ERUs), in order to further protect the environment.

The Linking Directive is based on Article 175 of the EC Treaty, providing thus for minimal requirements for the purpose of protecting the environment, and not for harmonized rules across Member States. A Member State may adopt more stringent measures pursuant to Article 176 of the EC Treaty but it would have to justify that any such measure further protects the environment and notify it to the European Commission. Whenever a Member State adopts more stringent measures pursuant to Article 176 of the EC Treaty, the Commission is granted the power to check the compatibility of those measures with other Treaty provisions, particularly those relating to the free movement of goods (article 23 of the EC Treaty). In that context, when transposing the Linking Directive, a Member State would therefore be required to demonstrate that its own standards for the approval of Hydro CERs (and in general any policy measure adopted by a Member State) fully respect the necessity and proportionality principles under which measures are strictly limited to what is necessary to achieve the pursued objective. In such a case, the pursued objective would be to further protect the environment by adding more stringent requirements on the use of Kyoto credits generated by a certain type of projects, namely large hydro project activities. But, because all CERs are fully fungible, this Member State should demonstrate that there is a direct link between the project itself, which is developed outside the EU, and the credit to which access or use within the EU would be restricted. In other words, it would be required to demonstrate a direct link of causality between the restriction put on the use of the credit and its effect on the improvement of environmental protection at the site level. Apart from arguing that the possibility to use



CLIMATE FOCUS

these credits within the EU ETS creates a demand for them by stimulating investments in such projects, it can hardly be argued that generally all hydro projects are bad for the environment, in as far as such assessment would have to be done on a case by case basis. For these reasons, it is unlikely such measures could be justified.

Furthermore it is unlikely such measures would be upheld under EU Law. First, such measures even if non-discriminatory, would be contrary to the well established mutual recognition principle first set forth in the ECJ's Cassis de Dijon decision.¹⁰ This jurisprudence has laid down the principle that any product legally manufactured and marketed in a Member State must be allowed onto the market of any other Member State. While the Court of Justice has recognised that over and above the rules set out in Article 23 of the EC Treaty, the Member States may make exceptions to the prohibition of measures having an equivalent effect on the basis of mandatory requirements such as the protection of environment,¹¹ it would be difficult for a Member State to successfully argue that further restrictions on the use of CERs or ERUs is "mandatory". Therefore, it is very likely such measures would be viewed as invalid under this principal of EU Law.

Finally, the Registry Regulation does not provide for additional measures limiting or excluding certain types of CERs.¹² If a Member State decides to allow (this is optional) entities to use CERs and ERUs for compliance purposes, it has to transpose such authorization into national law. This entails the creation of rights for the Member State's operators to use CERs (and ERUs) for the purpose of surrendering them in lieu of EU allowances to cover their actual emissions in accordance with provisions laid down in article 12 of the EU ETS Directive. If a Member State would decide to restrict some CERs from being used, it would have to notify the Commission of this and take special measures to prevent such CERs from being used for compliance within its national registry. It would need to give explicit instructions to its registry administrator to do so. The Registry Regulation does not provide registry administrators with the authority to implement limitations beyond those recognized under the Regulation.

4 Conclusions

The Linking Directive's approval requirement for large hydro projects has created confusion among both Member States and private entities. Even though the World

¹⁰ Case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein* (Commonly referred to as the Cassis de Dijon decision).

¹¹ See e.g. Case 302/86, *European Commission v. Denmark* () .

¹² See Registry Regulation, fn.5 above.



CLIMATE FOCUS

Commission on Dam's guidelines have an important value in contributing to the sustainability of hydroelectric projects, it is doubtful to what extent it can be directly applied in the assessment of existing or planned hydropower project. Obstacles to the EU trade of CERs from large hydro projects will ultimately lead to EU buyers abandoning such projects. In order to provide legal security to the participants in the carbon market, the EU Commission would be well-advised to consider harmonization of criteria applicable to the Member States' approval of hydro projects.

Despite this need for greater specificity on large hydro project approval under future EU Law, an examination of current EU Law reveals that while Member States are currently allowed discretion in the approval of large hydro projects, such discretion is not allowed regarding the recognition of CERs from these projects. Hydro CERs are mutually recognized and freely tradable among Member States at this time, and any efforts by a Member State to place restrictions on this fungible nature of Hydro CERs would very likely be invalid under EU Law.

Climate Focus Legal Team

Contact Information:

Climate Focus B.V.
Minervahuis III
Rodezand 34
3011 AN Rotterdam
The Netherlands
Tel. +31 10 217 5999
Fax + 31 10 217 5990
info@climatefocus.com