

# CONFIDENCE THROUGH COMPLIANCE IN EMISSIONS TRADING MARKETS

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*Prepared for*

**The International Network for Environmental Compliance & Enforcement (INECE)<sup>2</sup>**

*for its Workshop*

**Confidence Through Compliance in Emissions Trading Markets<sup>3</sup>**

*A Workshop To Identify Linkage Issues, Promote Effectiveness, and  
Emphasize The Importance of Achieving High Rates of Compliance in Emissions Trading Systems*

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## 1 INTRODUCTION

Emissions trading is a market-based mechanism designed to allow firms to choose the most cost-effective strategy to meet environmental standards. The success of SO<sub>2</sub> and NO<sub>x</sub> emissions trading systems in the U.S. and the launch of the ambitious European Union Emissions Trading System (EU ETS) underscore the value of emissions trading as a tool for environmental policy.

As more and more countries accept the need to address climate change on a priority basis, emissions trading will play an increasingly significant role as governance strategy that not only creates incentives for firms to cut greenhouse gas (GHG) emissions but also spurs technological innovation that ensures that this is done at the lowest cost. But only with high levels of compliance will emissions trading systems achieve reductions in GHG emissions efficiently, effectively, and equitably. Achievement of high levels of compliance hinges on robust and effective strategies for monitoring, reporting, and verification, where confidence in the system relies on timely and accurate information on emissions levels, allowance holdings, and trades. Without such reliable data, the system fails to meet its environmental objectives.

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<sup>2</sup> INECE is the only global network of independent experts dedicated to pursuing the rule of law, good environmental governance, and sustainable development at all levels of governance, local to global, INECE links the environmental compliance and enforcement efforts of more than 4,000 practitioners - inspectors, prosecutors, regulators, parliamentarians, judges, and NGOs - from 120 countries, through training and capacity building programs, raising awareness, and enhancing enforcement cooperation.

<sup>3</sup> The workshop is convened by INECE, in cooperation with its partners, The Netherlands' Ministry for Housing, Spatial Planning and the Environment (VROM), The Environment Agency (England and Wales), the European Commission, the US Environmental Protection Agency, the Washington College of Law at the American University, and Resources for the Future. For more information, see <http://www.inece.org/emissions>.

The central focus of the workshop *Confidence Through Compliance in Emissions Trading Markets* is the monitoring, reporting, and verification (MRV) aspects of emissions trading and associated cross-border strategies and issues, as these are the main elements of any effective compliance & enforcement strategy.<sup>4</sup> The International Network for Environmental Compliance & Enforcement (INECE), in cooperation with its partners, The Netherlands' Ministry for Housing, Spatial Planning and the Environment (VROM), The Environment Agency (England and Wales), the European Commission, the US Environmental Protection Agency, the Washington College of Law at the American University, and Resources for the Future, is convening the Workshop as follow-up to "International Conference on Compliance and Enforcement of Trading Schemes in Environmental Protection," hosted by The Environment Agency and INECE in March 2004 at Oxford University.<sup>5</sup>

The Workshop will explore the role of compliance and enforcement (C&E) strategies in emissions trading systems as essential elements to maintaining a trading system's environmental effectiveness and economic efficiency.

Specifically, the Workshop will seek to:

- Develop a set of best practices for achieving C&E in emissions trading programs;
- Raise awareness of the value and importance of trading programs and emphasizing the role that C&E play in achieving environmental objectives and ensuring market credibility and investor confidence;
- Identify key requirements of effective emissions trading systems; and
- Assess available information and define additional needs for creating an operational "common currency" and a network allowing (inter)national trading among different trading systems.

The Workshop will result in the production of a document summarizing the best practices and lessons learned from participants' experiences and a two-page fact sheet on elements of effective emissions trading systems. The Workshop will also produce an outline of the basic elements for facilitating an "international common currency" for emissions trading based on comparable C&E practices.

This background paper examines MRV strategies of the EU ETS, the United States Environmental Protection Agency's (US EPA) SO<sub>2</sub> and NO<sub>x</sub> trading programs, and, to the extent applicable, the new Dutch NO<sub>x</sub> trading system. This paper also compares regulatory cultures and MRV models in the EU and US and highlights key challenges to achieving high levels of compliance.

## **2        COMPARING REGULATORY CULTURES AND MODELS**

### **2.1     Introduction to Key Concepts**

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<sup>4</sup> See generally MAKING LAW WORK: ENVIRONMENTAL COMPLIANCE & SUSTAINABLE DEVELOPMENT (Durwood Zaelke, Donald Kaniaru, & Eva Kružíková eds., 2005).

<sup>5</sup> For more information, see <http://www.inece.org/emissions/workshop.html>.

The use of emissions trading systems as an alternative to more traditional forms of regulation requires a fresh look at the relationship between the regulator and the regulated community and other key regulatory concepts.<sup>6</sup> This section explores the different responsibilities and risks of emissions trading systems for both the regulator and the regulated community.

### *2.1.1. Monitoring, Reporting, and Verification*

Under traditional command-and-control regimes, firms must follow a relatively strict set of procedures to meet environmental standards and are sanctioned when they fail to do so. By comparison, under emissions trading systems, firms are free to choose their own compliance strategy – where they must decide how much to emit and how many allowances to trade. For the regulator, this choice presents a new set of responsibilities. To be able to sanction firms whose emissions exceed their allowance holdings and provide market participants with timely and accurate information, the regulator must track both the emissions levels and the number of allowances each firm possesses at a given time. As many systems involve self-reported data, the regulator must consider penalties for firms that falsify information.

Consequently, the regulator’s role is “no longer that of grandly deciding what is best for firms and individuals, entertaining equitable appeals, and enforcing the results.”<sup>7</sup> Rather, the regulator acts more like an accountant or a bank’s credit department.<sup>8</sup> This results in an emissions trading system whose market efficiency, investor confidence, and ability to meet emissions reduction targets hinge on the MRV strategies the regulator chooses to implement and enforce in the pursuit of high levels of compliance.

### *2.1.2. Common Interests in Compliance*

Unlike command-and-control regimes, participation in an emissions trading system allows for both the regulator and the regulated community to share a common interest in pursuing high levels of compliance. Because allowances are an intangible asset,<sup>9</sup> a firm that invests in allowances to cover some of its emissions has the same concerns as the regulator over market integrity and the need for fraud-proof MRV in order to avoid cheating and other risks that would decrease the value of allowances and possibly undermine the system altogether.

Originally, the EU’s interest in market-based systems was at least in part driven by the EU’s mixed record on implementation.<sup>10</sup> The European Commission and the European Court of Justice<sup>11</sup> could not always ensure adequate implementation, enforcement, and, by extension, compliance. This is partly why the European Commission initially preferred a carbon/energy tax to tackle climate change. It was thought that member states had an interest in improving on implementation and enforcement to collect the revenues

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<sup>6</sup> See John K. Stranlund, Carlos A. Chavez, & Barry C. Field, *Enforcing Emissions Trading Programs: Theory, Practice, and Performance*, 30(3) POLICY STUDIES JOURNAL 343 (2002), reprinted in MAKING LAW WORK: ENVIRONMENTAL COMPLIANCE & SUSTAINABLE DEVELOPMENT, 113-42 (Durwood Zaelke, Donald Kaniaru, & Eva Kružíková eds., 2005).

<sup>7</sup> See Ellerman, D (1998), Emissions Trading and Environmental Policy, THE EMISSIONS TRADER 2(4):1-5.

<sup>8</sup> Kruger, J (2005), “Companies and Regulators in Emissions Trading Programs”, RESOURCES FOR THE FUTURE, Discussion Paper 05-03, February 2005; p.10.

<sup>9</sup> That is, they behave like property rights in a market.

<sup>10</sup> The compliance gap between EU member states has been identified as early as the 1990s.

<sup>11</sup> The European Commission as the “Guardian of the treaty” has responsibility to ensure that EU legislation is properly transposed into national law and to supervise implementation. The latter task requires close co-operation with member states.

associated with tax. But the tax proposal was eventually abandoned due to lack of support among EU governments.

### 2.1.3. *Transparency and Public Perception*

Transparent regulatory regimes and markets provide the public with timely and accurate information based on MRV data as a means to instill trust and confidence in the market with evidence of high compliance. Given the importance and sensitivity of MRV data, it only follows that the market participants and the public in general are more likely to trust its veracity if the process by which it is collected and verified is perceived as open and accountable.

Transparency also helps counter some of the negative misconceptions about emissions trading systems, such as that they provide polluters with the right to pollute.<sup>12</sup> In fact, emissions trading systems, consistent with the polluter pays principle, help pass some of the cost of pollution control to the consumer of pollution-intensive products by imposing the costs of environmental harm on those who cause it and those who benefit from it.<sup>13</sup>

## 2.2 Comparing Regulatory Cultures

The following section describes the regulatory cultures both for the US and the EU respectively. The description of the EU regulatory culture will concentrate on the EU layer of government and make references to the differences among EU member states when necessary. When comparing the two cultures, it is important to keep in mind two fundamental differences between the US and EU. First, the US system has been up and running for the past decade while the EU ETS began this year and must still be considered a “work in progress.” Second, the US programs operate within a single jurisdiction, while the EU ETS is subject to a multi-jurisdictional political environment.

### 2.2.1 *US Regulatory Culture*

The US has more than a decade of experience with operating cap and trade programs, and there are well-established procedures for compliance and enforcement. In general, these programs are operated centrally by US Environmental Protection Agency (EPA).<sup>14</sup> MRV for the US SO<sub>2</sub> and NO<sub>x</sub> programs is characterized by detailed rules, electronic reporting and auditing, and a variety of quality assurance and quality control requirements. Although continuous emissions monitors (CEMs) play an important role in US programs, many sources are permitted to use alternative methods to measure emissions, such as approaches utilizing fuel meters and emission factors.<sup>15</sup> Finally, although the MRV system used in US trading programs has not been used to implement a CO<sub>2</sub> trading system, it *has* been used to collect and verify CO<sub>2</sub> emissions data

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<sup>12</sup> See, e.g., Kruger, J., *Companies and Regulators in Emissions Trading Programs*, RESOURCES FOR THE FUTURE, Discussion Paper 05-03, February 2005, citing the example of an opinion piece in *US Today*, arguing that as a result of allowance trading people would die. For a long period there have been claims by some EU policy makers that Europeans do not like a situation where people make money with pollution. During the discussions and negotiations, such opposition was also heard from some parts of the NGO communities and occasionally from parliamentarians.

<sup>13</sup> ROBERT COSTANZA, ET AL., *AN INTRODUCTION TO ECOLOGICAL ECONOMICS 205* (St. Lucie Press, 1997).

<sup>14</sup> Note, however, that some States participate in monitoring activities in both the SO<sub>2</sub> and NO<sub>x</sub> programs and State governments have the lead in enforcement actions in the NO<sub>x</sub> program.

<sup>15</sup> For example, although 96% of emissions in the US SO<sub>2</sub> program are monitored with CEMs, only 36% of regulated “units” are required to use CEMs.

from the electric power sector.<sup>16</sup> This section will focus largely on the regulatory culture and approach of the US SO<sub>2</sub> and NO<sub>x</sub> programs. Later in the paper, there will be a brief discussion of the issues that would arise if the US were to develop a compliance system for a greenhouse gas program.

In US SO<sub>2</sub> and NO<sub>x</sub> programs, approximately 75% of staff resources (75 people, including personnel in regional EPA offices and state agencies) are focused on the measurement, verification, and tracking of emissions data. Government administrators also provide policy guidance on measurement issues, develop and operate the information systems that track emissions and allowances, certify monitoring equipment, verify reported emissions data, and audit facilities.<sup>17</sup>

Although the main organizing principle of program administrators is maintaining accountability for the system, an important secondary goal is providing administrative certainty. Program administrators have tried to create administrative certainty by making program operations routine and not subject to discretion. The routine nature and lack of regulatory discretion of the US trading programs manifests itself in several ways. First, the rules for emissions monitoring are detailed and prescriptive, leaving little discretion for either companies or regulators. Second, there is heavy reliance on information technologies to operate the program and to automate routine procedures. Finally, excess emissions penalties are nondiscretionary and automatic. Following is a description of these aspects of the US model as well as a discussion of the compliance promotion role played by public access to emissions and allowance data.

#### *Monitoring, Reporting and Verification*

The MRV process begins with facilities choosing their monitoring equipment and sending a monitoring plan to EPA. Under some circumstances, participants may apply for alternative monitoring methods (e.g., in the SO<sub>2</sub> program, gas fired units may use fuel flow meters and emissions factors), which must be approved by EPA. Government authorities review monitoring plans and provide feedback to industry. Industry next must conduct a series of certification tests of their monitoring equipment and provide these test results to government authorities in the form of a certification application. After certification, facilities begin to monitor emissions and conduct ongoing quality assurance and quality control (QA/QC) testing requirements.

Participants in the programs must report emissions to EPA electronically every quarter in a standard format. Many participants use software developed by EPA or others pre-screen their electronic reports before sending them to EPA. This software runs many of the same checks as EPA's computers and is designed to minimize the numbers of errors in submitted reports.

EPA computers receive the electronic reports, review the data, and provide feedback to company officials. This electronic feedback is generally of three types. Officials at facilities are informed that either: (1) their data have been accepted and will be stored in EPA's database for the purpose of compliance determinations and public data dissemination; (2) their data have been rejected because of specified critical errors; or (3) their data have been accepted, but EPA has identified errors that must be corrected in later data submissions. If there are problems with the data, company officials are able to follow-up with EPA monitoring specialists who are assigned to their facilities.

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<sup>16</sup> Approximately 40% of units that report CO<sub>2</sub> emissions to US EPA use CEMs and 60% use alternative methods.

<sup>17</sup> US EPA (2003) *Tools of the Trade: A Guide To Designing and Operating a Cap-and-Trade Program for Pollution Control*, EPA 4330-B-03-002. Washington, US EPA, Office of Air and Radiation, at <http://www.epa.gov/airmarkets/international/tools.pdf>.

In addition to this first round of electronic review and processing, EPA uses software to audit the data and identify potential discrepancies or issues to investigate. These audits review emissions or measured fuel data as well as the results of quality assurance and quality control tests performed on the measurement equipment. EPA uses these electronic “desk” audits to target more in-depth field audits. Such field audits may include observing quality assurance tests, reviewing on-site records, inspecting measurement equipment, and/or comparing installed measurement equipment to independent reference methods. Field audits are usually done in teams together with state and local environmental agencies. Where possible, regulatory officials (usually from local agencies) observe QA/QC testing of emissions measurement equipment. The purpose of the audit is to verify that the testing is completed according to standard procedures and accurately represented in the reports to EPA. Field audits are performed on both random samples of all sources and on sources identified with potential measurement or data problems during the electronic desk audits.

#### *Detailed Rules for Emissions Monitoring and Reporting*

Monitoring rules are highly detailed in the US SO<sub>2</sub> and NO<sub>x</sub> programs. The regulations for monitoring cover almost 300 pages and provide thorough standards for installation and certification of monitors, quality assurance and testing, handling of missing data, recordkeeping, and other features. Most of these rules are now incorporated into software systems at both the companies and EPA so that the reporting and review of emissions reports are highly standardized.

To a certain extent, the use of continuous emissions monitors (CEMs) in the US trading system has required this more prescriptive approach. However, even when units use alternative emissions monitoring methods, the requirements are quite detailed. For example, there are 30 pages of regulations for a monitoring method used by gas-fired units that utilizes fuel metering and emissions factors.

To provide certainty and ensure consistency, EPA devotes extensive resources to answering and documenting questions that arise about monitoring requirements. EPA has an online policy manual that is largely in a question-and-answer format. It has been updated more than a dozen times over the life of the program and is now nearly 500 pages long. These detailed monitoring and reporting requirements, though complex, have provided companies with considerable certainty that, if they follow the procedures, their emissions reports will be accepted in a timely manner.

#### *Extensive Use of Information Technology*

The routine nature of the decisions that regulators make and the vast amounts of emissions and allowance data that must be handled have allowed regulators to build the operation of the trading program largely around information technology.<sup>18</sup> For example, companies are required to report emissions data to EPA in a standardized electronic format. Once the data are received, EPA computers run quality assurance tests and give electronic feedback to companies. Additional software is used to run electronic audits on emissions reports. Emissions data are maintained in a database that is accessible via the Internet.<sup>19</sup>

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<sup>18</sup> Kruger J, McLean B, Chen R (2000), *A tale of two revolutions: Administration of the SO<sub>2</sub> trading program*. In: R. Kosobud (ed) EMISSIONS TRADING: ENVIRONMENTAL POLICY'S NEW APPROACH. New York, John Wiley & Sons; Perez Henriquez, Blas (2004) *Information technology, the unsung hero of market-based environmental policies*. RESOURCES FALL/WINTER: 9-12.

<sup>19</sup> Husk M, DeSantis L (2002) *E-government and the clean air markets division*. CLEAN AIR MARKETS UPDATE 3(Winter):6.

EPA's allowance registry is similar to an online banking system, with companies able to manage their allowance accounts and make transfers without submitting paper forms. Approximately 80% of all transfers of allowances are now done over the Internet by the sources themselves. Similarly, EPA has implemented a new application that allows companies to log onto a secure site and perform functions that were previously done with paper forms. These include changing information about company officials who are authorized to act for an allowance account, submitting data about new or retired emissions sources, and determining whether a source is required to participate in the program.<sup>20</sup>

Electronic reporting and processing of data have been critical in meeting the tight timeframes for the annual compliance true-up period. Companies submit their final quarter's emissions data by January 31 and have until March 1 to transfer allowances and submit final compliance certification forms. EPA then completes verification of the annual emissions data and compares them electronically with allowances within the accounts of each unit. Typically, this process is completed by June.

Finally, through the development of standardized reporting formats and protocols, EPA and companies have meshed their data systems. Early in the program, EPA developed and distributed software to help companies develop their emissions reporting systems.<sup>21</sup> Software used by companies to track allowances and emissions incorporates standardized EPA electronic reporting formats and allows companies to compare their own records of allowance holdings with those in the EPA registry.

Compliance interactions between regulators and companies mainly involve resolving discrepancies over emissions data that arise in the quality assurance process. As discussed earlier, quarterly electronic reporting and feedback give companies adequate notice of data problems and time to correct these problems before the annual reconciliation of allowances and emissions data. Compliance is a largely routine process; allowances are electronically compared with emissions at each utility unit.

#### *Penalties and Enforcement Action for Non-Compliance*

The certainty that a penalty will be imposed is a critical element in providing the correct incentives in an emissions trading program. The automatic nature of excess emissions penalties in US trading programs contrasts with the traditional regulatory approach in the US, in which sources in violation negotiate for a regulatory exemption.<sup>22</sup> Administrators of the US trading program argue that the automatic nature of penalties and the certainty of other compliance-related provisions focus corporate resources and attention on low-cost compliance strategies, rather than on lobbying or litigating to reduce costs.<sup>23</sup> In addition to the automatic excess emissions penalties, there is the authority to assess both civil and criminal penalties in US trading programs. With an automatic penalty that is significantly higher than the market price for

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<sup>20</sup> *Id.*

<sup>21</sup> McLean BJ (1997) *Evolution of marketable permits: The U.S. experience with sulfur dioxide trading*. INTERNATIONAL JOURNAL OF ENVIRONMENTAL AND POLLUTION 8(1/2):19–36.

<sup>22</sup> Ellerman, AD, Joskow P, Harrison D (2003) *Emissions trading in the US: Experience, lessons, and considerations for greenhouse gases*. PEW CENTER ON GLOBAL CLIMATE CHANGE, Arlington

<sup>23</sup> Kruger, J., *Companies and Regulators in Emissions Trading Programs*, RESOURCES FOR THE FUTURE, Discussion Paper 05-03, February 2005.

allowances, and with a liquid market for allowances, there has been nearly 100% compliance with the SO<sub>2</sub> and NO<sub>x</sub> trading programs.<sup>24</sup>

### *Public Access to Data*

In the United States, emissions data from the SO<sub>2</sub> and NO<sub>x</sub> trading programs are available to the public and may be accessed through the Internet. There are no confidentiality requirements for this data. The public can also access data on allowance transfers among different accounts in EPA's registry. Information technology has been the key to providing this transparency in the US emissions trading programs, with all emissions and allowance data available online.<sup>25</sup> Some commentators note that public access to emissions and trading data builds confidence in the environmental results of the program and provides an additional safeguard or incentive for compliance.<sup>26</sup> Environmental NGO's in the US have used emissions and allowance data for a variety of purposes, such as assessing the net environmental impact of emissions trades and analyzing and comparing emissions profiles of companies. EPA facilitates transparency of emissions and allowance data by providing it in user-friendly web-based formats. For example, tools on EPA's website allow users to make customized queries of the data that are of the most interest.<sup>27</sup>

### *2.2.2 The EU Regulatory Culture*

While there is little doubt that the EU ETS has strongly been influenced by the US SO<sub>2</sub> trading program and the NO<sub>x</sub> Budget Trading Program,<sup>28</sup> it differs in several important aspects. The principal difference is the high level of decentralization and the significant degree of discretion for member states in the implementation phase, even if compared to the NO<sub>x</sub> Budget Trading Program. For example, under the EU ETS, it is up to the member states to set policy on compliance and enforcement strategies as well as allocation, which includes the level of the cap and the exact methodology to be applied. The European Commission provides a broad set of guidelines for compliance and enforcement strategies, which give considerable flexibility to installations and to member states to develop specific monitoring procedures without imposing uniform, mandatory standards for emissions verification. The EU ETS also delegates emissions verification to member states, which are free to decide whether to rely on a government authority or a third party. Additionally, member states are responsible for defining competence requirements and the rules and procedures for verifier accreditation. Initially, the EU ETS Directive

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<sup>24</sup> In 10 years of operation, there have been 21 excess emissions penalties, ranging from \$2,682 to \$1,580,000. There have been nine additional civil penalties for other violations, such as failures to monitor and report emissions. See Kruger, J., and W.A. Pizer, *The EU Emissions Trading Directive: Opportunities and Potential Pitfalls*, RESOURCES FOR THE FUTURE, Discussion Paper 04-24, April 2004.

<sup>25</sup> Kruger J, McLean B, Chen R (2000), *A tale of two revolutions: Administration of the SO<sub>2</sub> trading program*. In: R. Kosobud (ed) EMISSIONS TRADING: ENVIRONMENTAL POLICY'S NEW APPROACH. New York, John Wiley & Sons.

<sup>26</sup> US EPA (2003) *Tools of the Trade: A Guide To Designing and Operating a Cap-and-Trade Program for Pollution Control*, EPA 4330-B-03-002. Washington, US EPA, Office of Air and Radiation, at <http://www.epa.gov/airmarkets/international/tools.pdf>; Tietenberg T (2003) *The tradable permits approach to protecting the commons: Lessons for climate change*. OXFORD REVIEW OF ECONOMIC POLICY 19(3):400-419.

<sup>27</sup> Husk M, DeSantis L (2002) *E-government and the clean air markets division*. CLEAN AIR MARKETS UPDATE 3(Winter):6.

<sup>28</sup> For example, note the 1999 study by the Center for Clean Air Policy (CCAP) commissioned by DG Environment of the European Commission. Similarities include particularly the choice of a cap-and-trade model, grandfathering, emphasis on monitoring, reporting and verification, transparency and public involvement. See, e.g., Kruger, J., and W.A. Pizer, *The EU Emissions Trading Directive: Opportunities and Potential Pitfalls*, RESOURCES FOR THE FUTURE, Discussion Paper 04-24, April 2004; Greenhouse Gas Trading in Europe: *The New Grand Policy Experiment*, ENVIRONMENT, 46, 8, pp. 8-23, October 2004.

foresees that each member state will have its own registry,<sup>29</sup> although joint registries between member states are permitted. Consequently, this decentralized approach leaves the European Commission Monitoring & Reporting Guidelines (MRG) about one-fourth the size of respective guidelines in the US and much less detailed.

A decentralized approach is consistent with the makeup of the EU political system, based on sovereign member states with their own legal systems, traditions, and languages, where the EU layer of governance (Council of Ministers and the European Parliament) agrees on the framework and member states enjoy a high level of discretion in implementing in their respective jurisdictions.<sup>30</sup> As there are as many jurisdictions as member states, one-size-fits-all policies seldom are an option.<sup>31</sup> Consistency across member states is sought by so-called Comitology Committees, consisting of European Commission and member state officials who are responsible for the harmonization of implementation provisions. The mandate (and hence the limit) of Comitology Committees are set both by the relevant provisions in the Directive and EU primary, secondary and case law such as EC internal and competition law.<sup>32</sup> Despite the fact that the EU exhibits elements of a federal system, one would miss the very essence of the diversity within the EU if one would perceive it as a federation.

The high degree of decentralization is – at least partly – also the result of consensual decision-making in the EU.<sup>33</sup> As the EU is made up of sovereign states, effective implementation of EU laws by member states is best ensured if legitimate member states' concerns are taken into account during the negotiations in the Council of Ministers when the laws are formulated. As a result, initially the EU tends to choose decentralized options, followed by steps to establish and coordinate a common approach among member states. In the EU ETS framework, a common approach relies on using best practices to address issues jointly and share experiences among member states. But initial experiences usually feed into a formal review, which in many cases – including for the EU ETS – is built into the legislation.<sup>34</sup> Market solutions have in many instances proven easier than harmonization across 25 or more national jurisdictions, which display major differences in legal systems, enforcement cultures and administrative capacities. In many cases, EU legislation is initiated by national legislation, reinforcing the tendency towards decentralization.<sup>35</sup>

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<sup>29</sup> Registries are a precondition to track allowance account information, allowance holdings and transfers of allowances among trading participants as well as government administrative functions such as setting up allowance accounts, issuing or retiring of allowances.

<sup>30</sup> Law that is adopted by the EU needs to be implemented and enforced by member states. This is among other laid out in the principle of Community loyalty in Article 10 of the EC Treaty that guides the EU.

<sup>31</sup> In some cases, implementation of a EU law goes even beyond EU member states and may include non-EU countries grouped in the so-called European Economic Area (EEA). The concept of the EEA has been developed for those countries that do not wish to share the political objectives of the European Union such as progressive political integration but want to benefit from economic integration. It allows for the full (and legally binding) integration of countries into the EU internal market without being member. This approach is currently being applied to Iceland, Liechtenstein and Norway. *See, e.g.*, Emerson, M, Vahl, M. and Woolcock, S. (2002), "Navigating by the Stars: Norway, the European Economic Area and the European Union". CEPS Paper. Brussels. Centre for European Policy Studies.

<sup>32</sup> The European Commission and the European Court of Justice have the right to control implementation and enforcement. However, this always requires co-operation of member states.

<sup>33</sup> Although the EU ETS as almost all other internal market-related legislation can be adopted by a qualified majority, voting is used only in exceptional cases. This is even more true for important laws. The EU ETS was adopted unanimously by the Council of Ministers and by a large majority in the European Parliament.

<sup>34</sup> The EU ETS review is mandated to start in mid-2006 at the latest.

<sup>35</sup> For the case of the EU ETS, *see e.g.* Zapfel, P. and M. Vainio (2002), "Pathways to European Greenhouse Gas emissions: History and misconception". NOTA DI LAVORO 85.2002. Fondazione Eni Enrico Mattei (FEEM).

Because the EU ETS began this year, it has not yet completed its first Reporting & Monitoring cycle. The following section therefore only describes the basics of the EU MRV process as designed by the Directive and implementation provisions.

Each installation covered by the EU ETS needs to apply for a GHG emission permit,<sup>36</sup> which *inter alia* requires monitoring and reporting of emissions. Article 14 in the EU ETS Directive requires the European Commission to adopt legally binding Guidelines for Monitoring and Reporting (MRG)<sup>37</sup> of emissions based on Annex IV of the Directive, which include accuracy, timeliness, and integrity. The framework on monitoring and reporting is completed by verification and a registry.

The MRG require member states to develop monitoring methodologies for installations in their jurisdictions. These methodologies are principally based on a combination of emissions factors, fuel use, and production data.<sup>38</sup> The MRG sets for different “tiers” of monitoring methodologies, with the top tier the most accurate (and usually most expensive). Installations are required to use the top “tier” unless they can show it is impractical or will result in disproportionate costs. In these cases, the Competent Authority (CA), or responsible agency in each member state, can waive this obligation and drop the installation’s methodology to a lower tier.<sup>39</sup>

With the exception of Germany, member states have agreed that the installation-specific monitoring methodology should be part of the permitting procedure.<sup>40</sup> Installation-specific methodologies are submitted for approval to the CA. The underlying philosophy is to reduce the possibility of error and instill confidence for both participants and regulators.

Operators at each installation report their emissions according to the methodology specified in its permit. Though operators must ensure its report complies with the applicable methodology, an independent third party must verify all self-reported emissions. This can be either a government body or, more likely, an accredited verifier.<sup>41</sup> The verifier determines whether emissions have been monitored and reported in accordance with the validated methodology in the permit. In some countries (e.g. UK, Germany, Portugal) verifiers have also checked baseline emissions.

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<sup>36</sup> Different member states use different terminology (for example, the Plan in the UK or protocol in the Netherlands).

<sup>37</sup> European Commission (2004), “Commission Decision establishing guidelines for the reporting of greenhouse gas emissions pursuant to Directive 2003/87/EC of the European Parliament and of the Council”, OFFICIAL JOURNAL OF THE EU (OJ), L 59, pp. 1-74 of 26.2.2004

<sup>38</sup> MRG define “monitoring methodology” as “the methodology used for the determination of emissions, including the choice between calculation or measurement and the choice of tiers”, i.e. a hierarchy of different ambition levels.

<sup>39</sup> US-style *continuous emissions monitors* are possible but are not expected to be used. Note that there is a difference in opinion between European and U.S. officials about the benefits of CEMs. In Europe, there are doubts about the value from both from a cost and accuracy point of view. In the U.S., CEMs have been viewed as highly accurate and cost effective for monitoring of SO<sub>2</sub> and NO<sub>x</sub> at certain types of sources. See section 3.3.1. for a discussion of the use of CEMs in a potential U.S. greenhouse gas trading program.

<sup>40</sup> Germany set out its monitoring and reporting requirements in the permits by reference to general rules.

<sup>41</sup> The Directive requires verified data in accordance with a number of criteria set out in Annex V of the Directive, such as the quality and accuracy of the measuring equipment, effective data management systems, transparency of processes and public access to data.

Because the verifier has the final say on an installation's report, particular importance is attached to ensure that the verifiers perform their task accurately. Accordingly, the CA must ensure that accredited verifiers are qualified and supervised via regular inspections and sample controls.

Although verifiers' tasks are similar to an auditor reviewing a firm's financial accounts, their work is distinct from financial auditors. Generally, verifiers are organizations such as environmental management or consulting firms that, for example, had been involved in certification systems. They employ qualified engineers who are familiar with the technical issues of emissions measurement. Some member states are making provisions for verifiers and financial statements auditors to work together to reduce costs. There is co-ordination at EU level to promote consistency in the accreditation process for verifiers. But there is as yet no harmonized approach, as competence requirements for verifiers are still being defined.

Similar to the US, EU member states try to create administrative certainty by making program operations routine. For example, the Netherlands have developed a standard validation protocol aimed at ensuring that the monitoring protocols proposed by the operators in their request for a permit would be approved ("validated") in a uniform way. This was to limit discretion in the validation process. A second protocol, on verification protocol, which was developed in early 2004. This protocol has been used the European Co-operation for Accreditation (EA), a voluntary co-operation of European Accreditation bodies, to develop its Guidance on Verification (EA 6/03). A number of member states have made the use of EA 6/03 obligatory in their national legislation. Some member states concentrate on improving national verification *procedures, while other member states are yet undecided*. In the future, it is likely that the European Commission will provide more guidance as to achieve a higher degree of standardization of procedures. Although there is far less reliance on information technologies to operate the program and to automate routine procedures, some member states such as Finland, the Netherlands or the UK have started to progressively use standardized electronic formats.

There is an important similarity between the US and the EU in that excess emissions penalties are nondiscretionary, automatic,<sup>42</sup> and significantly higher than the market price for allowances (*see* section on the importance of non-discriminatory and automatic penalties in the US). But in line with the far more decentralized political environment of the EU, administrative and criminal penalties are entirely the responsibility of member states, as the EU has no competence in this area. However, relevant member states provisions need to be communicated to the European Commission.

Reported emissions data is collected in a registry that can be used to measure compliance by comparing the verified emissions of an installation with the number of allowances the installation holds, which is also known as the tracking of allowances. The registry amounts to a hub and spokes system consisting of one European hub in the form of the EU transaction log and 25 different member states registries, which communicate through standardized protocols and the EU. In the future, it is anticipated that member states will develop joint registries (*see* below). It is interesting to note that the Dutch NO<sub>x</sub> trading system initially had no automated registry, but the government decided to make maximum use of the procedures and structures as defined in the EU-ETS, and thus seeking the maximum synergy possible between the two schemes

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<sup>42</sup> The EU example shows that governments faced barriers within national administrations to design and apply nondiscretionary and automatic penalties. Reason was that such penalties have not been foreseen in existing administrative, legal and procedural requirements. In some cases, law making instructions would even prevent them.

Emissions data will be publicly available as of the completion of the first Monitoring & Reporting Cycle (31st of March 2006). Under article 17 of the ETS Directive, a full emissions report for every single installation needs to be published. Modalities for this are under discussion by member states, where making the data available online through a web page for each national registry has been discussed. Access to information and transparency in general depend on the degree of user-friendliness of the published data. Therefore, verified emissions of installations will be entered into a Verified Emissions Table of a member state registry. The Central Administrator and each member state registry on 15 May each year will display on their public website the verified emissions figure for each installation as well as the allowances surrendered for that installation and whether or not that installation is in compliance with its obligations. The emissions figure for every single installation can be accessed through the CITL (Community Independent Transaction Log) web site. This process should be largely routinized.

### **2.3 Comparing the Two Models**

The figures and accompanying text listed below, and located in Annexes I, II, and III, provide additional comparisons and overviews of the EU and US MRV models.

Figure 1: *Monitoring, Reporting, and Verification in the EU* in Annex I.

Figure 2: *Monitoring, Reporting, and Verification in US Trading Programs* in Annex II

Figure 3: *MRV: Differences & Similarities of US and EU Emissions Trading Schemes* in Annex III

## **3 CONFIDENCE THROUGH COMPLIANCE**

### **3.1 High Levels of Compliance Is Essential To Successful Emissions Trading Systems**

With emissions trading systems, it is not just the regulator who is concerned about compliance. The regulated community and other participants and investors all share a common interest with regulators in achieving high levels of compliance. Otherwise, cheating or even the perception of cheating can risk devaluing allowances, thereby reducing or eliminating the economic incentive to cut emissions. To underscore this common interest in compliance, it is worth examining the different perspectives of participants in emissions trading systems.

### **3.2 Participant Perspectives**

Participants in the emissions market require a stable and predictable environment. At the same time, governments, citizens, and environmental NGOs demand that environmental objectives are met. By and large, these two priorities, i.e. stability and efficacy, are compatible and even mutually dependent. Even if emitters, governments and environmental NGOs are likely to hold different views on the severity of the targets, the “market” prefers credible targets, which not only increase liquidity but also reassure governments and society that the trading process will lead to credible reductions in GHG emissions. Consistent and fraud-proof monitoring and verification procedures therefore have moved to the centre of

emissions trading schemes. While in the beginning this debate focused on accuracy and credibility, with progressive implementation the spotlight turns to costs, notably how to reduce them.

### *3.2.1. EU Governments' Perspectives*

Interest in emissions trading in the EU has been triggered by a number of different reasons. First were potential economic merits. Emissions trading promises least-cost abatement and allows industry a high degree of flexibility in how to meet the environmental objectives. Second, emissions trading was seen as particularly well-suited to climate change policy as a means of translating absolute national targets into sector- and installation-specific targets. Third, governments were attracted by the cap, which gives assurance that the environmental objective is met. It was thought that emissions trading could be a means to address implementation and enforcement deficits that were increasingly becoming apparent within the EU and were expected to widen with enlargement. Finally, after aborted attempts by the EC to institute a carbon tax and industry to reach voluntary agreements to cut emissions, a market-based system became the most attractive option to confront climate change, especially when compared to the largely unworkable command-and-control alternatives.

Success with the EU ETS, both in terms of reducing emissions and establishing mandatory trading systems as a useful regulatory strategy to confront climate change, is essential for the EU to maintain its credibility in international climate negotiations. While success for the EU ETS depends on a variety of factors, its MRV strategies will play a large role in its environmental effectiveness, economic efficiency (including establishing a level playing field for businesses throughout the EU and the world), and political acceptability.

### *3.2.2 US Government Perspective*

Emissions trading has become the policy of choice for legislators and program administrators in the US to address regional air pollution. This is both because the programs have proven effective and because the programs have satisfied a variety of competing interests.

Without a doubt, the existence of stringent monitoring and enforcement provisions in the 1990 Clean Air Act gave policy makers the confidence to experiment with the flexibility of the cap and trade approach. Most recently, all of the major legislative proposals in Congress for further reductions of multiple pollutants featured a cap and trade structure. Finally, although there is still controversy in the US about the adoption of a cap on greenhouse gases, emissions trading is generally viewed as the inevitable approach if the US adopts a mandatory policy.

### *3.2.3 Regulated Firms, Market Participants and Investors*

Business and industry have supported the introduction of emissions trading largely because they are identical to government's motives, although the weighting of motivations varies. While business and industry may value least-cost abatement and flexibility the most, they also can see the additional advantage of management focus on cost-effective abatement possibilities. Managers will try to exploit opportunities through better carbon management and participation in the trading market. The realization of such opportunities requires efficient and effective MRV.

Firms operating in the EU generally favor the economic advantages of emissions trading systems, given the superior degree of accuracy emissions trading systems have had in meeting regulatory targets. But the future of the EU ETS, which has been mostly favored by industry, depends on its credibility. Effective MRV strategies play a key role here by boosting its credibility as well as helping firms identify overlooked reduction opportunities as the experience of BP and others suggest.<sup>43</sup>

Other participants in the system have a somewhat different perspective. Industry participants are most interested in establishing and maintaining a level playing field – that is, that firms believe their competitors are in compliance and, if not, will be identified and sanctioned.

In addition, investors and traders are generally most interested in determining how sheltered allowances are from the risk of devaluation. In other words: they don't want to lose money investing in carbon. The two main sources of risk of devaluation are widespread cheating and uncertainty brought on by ineffective MRV strategies and a wholesale change in regulatory policy.

The perspectives of industry and market participants in the US are similar to those in Europe. Svendsen found that the flexibility of the cap and trade approach, coupled with increased competition in the electric power sector, is one of the main reasons the US electric power industry prefers a grandfathered tradable permits market over other regulatory approaches.<sup>44</sup> One industry representative notes that US trading programs have worked well because the role of regulators is to “to get the system up and working, to ensure compliance, and to report on progress.”<sup>45</sup> Swift argues that this focus on emissions results rather than compliance choices creates less friction between regulators and companies because it reduces transaction costs and avoids delays inherent in the review of industry strategies.<sup>46</sup> This represents a considerable improvement over earlier emissions trading programs, in which case-by-case reviews of trades contributed to delays and uncertainties.<sup>47</sup> Similarly, brokers and traders have also supported strong compliance provisions as a prerequisite for the development of the market. For example, one broker has noted in testimony before the US Congress:

There is no ‘natural benefit’ for owning a tradable emissions right. Their only value is compliance with the law. Consequently, there must be a fate worse than trading if trading is to succeed. Accordingly, penalties for non-compliance must be severe when compared

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<sup>43</sup> BP calculated that reducing GHG emissions by 10% below its 1990 level had a net benefit of \$ 650 million. Reductions were a direct consequence of the internal BP cap-and-trade scheme. The associated MRV enabled the company to identify reduction sources. See J Browne, “Beyond Kyoto”, FOREIGN AFFAIRS, Vol. 83, No. 4, August 2004, pp.20-32. Similar experiences were reported by Ennergy, Toyota or Rio Tinto.

<sup>44</sup> Svendsen GT (1999) *U.S. interest groups prefer emission trading: A new perspective*. PUBLIC CHOICE 101:109–128.

<sup>45</sup> Kruger, J., *Companies and Regulators in Emissions Trading Programs*, RESOURCES FOR THE FUTURE, Discussion Paper 05-03, February 2005. See also Chartier D (1997) Statement by Daniel L. Chartier, manager, emissions trading, Wisconsin Electric Power Company, before the Joint Economic Committee, U.S. Congress. July 9; Hart G (2000) *Southern Company's BUBA strategy in the SO<sub>2</sub> allowance market*. In: Richard Kosobud (ed) EMISSIONS TRADING: ENVIRONMENTAL POLICY'S NEW APPROACH. New York, John Wiley & Sons; and McManus J (2001) *Compliance experience of regulated entities*. In: ACID RAIN: ARE THE PROBLEMS SOLVED? Conference proceedings. Center for Environmental Information, Rochester, for industry views on the SO<sub>2</sub> trading program.

<sup>46</sup> Swift B (2001) *How environmental laws work: An analysis of the utility sector's response to regulation of nitrogen oxides and sulfur dioxide under the Clean Air Act*. TULANE ENVIRONMENTAL LAW JOURNAL 14:309.

<sup>47</sup> Hahn RW, Hester GL (1989) *Marketable permits: Lessons for theory and practice*. ECOLOGY LAW QUARTERLY 16(361):397.

to the costs of trading (including the time and effort to execute the trades). And, just as importantly, penalties must be enforced.<sup>48</sup>

While industry generally supports monitoring and verification provisions in the SO<sub>2</sub> and NO<sub>x</sub> Programs, some companies have expressed concerns about the high monitoring costs and complexity related to continuous emissions monitors. Ellerman et. al. found that these costs were as much as 7% of overall compliance costs during the first phase of the SO<sub>2</sub> Program.<sup>49</sup> However, he also notes that “. . .regulated firms seem to be unanimous in expressing their preference for this type of regulation, presumably because the gains in reduced direct compliance costs more than offset whatever compliance costs are involved in monitoring. . .”<sup>50</sup>

### 3.2.4 Non-Governmental Organizations and the Public

In both the US and Europe, the main attraction for NGOs has been the environmental certainty as a result of an absolute cap.<sup>51</sup> Such certainty however depends on the credibility of MRV. Environmental NGOs demand that environmental objectives are met. Hence, there is convergence between emitters and NGOs, although the devil is in the detail.

## 3.3 Compliance Challenges

Effective implementation of MRV rules is central to provide trust in the system as well as to offer a major potential for efficiency improvements by bringing down costs associated with MRV and emissions trading in general. This has notably been demonstrated for US trading schemes such as the SO<sub>2</sub> trading and the OTC NO<sub>x</sub> Budget Trading Programs.<sup>52</sup> Arguably, for the US acid rain programs and the OTC NO<sub>x</sub> Budget Trading Program, measuring and monitoring have been the most complex and costly element components of the trading scheme. The EU ETS is somewhat different as GHG emissions are not actually measured, but calculated based on energy use or other proxies. This does however not automatically mean that the one of methods is superior to the other.

### 3.3.1 The US: Future Cap and Trade Compliance Issues and Challenges

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<sup>48</sup> Bartels D (1997) Statement by Carlton Bartels, Cantor Fitzgerald, before the Joint Economic Committee, U.S. Congress. July 9.

<sup>49</sup> ELLERMAN A. ET. AL. (2000) *MARKETS FOR CLEAN AIR: THE U.S. ACID RAIN PROGRAM*, CAMBRIDGE UNIVERSITY PRESS.

<sup>50</sup> Ellerman, AD, Joskow P, Harrison D (2003) *Emissions trading in the US: Experience, lessons, and considerations for greenhouse gases*. PEW CENTER ON GLOBAL CLIMATE CHANGE, Arlington .

<sup>51</sup> Early opposition to SO<sub>2</sub> trading by much of the environmental community in the US has faded as the program has shown significant environmental results and emission “hot spots” have not emerged. Kruger, J., and M. Dean. 1997. *Looking back on SO<sub>2</sub> Trading: What's Good for the Environment is Good for the Market*. PUBLIC UTILITIES FORTNIGHTLY 135 (15): 30-37.. However, there is still opposition to emissions trading of conventional pollution by some environmental groups. Most recently, much of this opposition has focused on mercury trading.

<sup>52</sup> See, e.g., Mangis, J. K., 1998. *The United States' sulphur dioxide emissions allowance program: an overview with emphasis of monitoring requirements and procedures and a summary report on US experience with environmental trading systems*, EEA TECHNICAL REPORT, No. 29; Holmstead, J., 2002. Testimony at US House of Representatives, ‘Accomplishments of the Clean Air Act, as amended by the Clean Air Act Amendments of 1990’, Hearing before the Subcommittee on Energy and Air Quality of the Committee on Energy and Commerce, House of Representatives, one hundred seventh Congress, second session, May 1, 2002. Serial no. 107-106.

Although compliance procedures for US SO<sub>2</sub> and NO<sub>x</sub> programs are well established, there is much uncertainty about the design of any future mandatory program for greenhouse gases in the US. There are a number of factors that could shape the MRV procedures of such a program. Key questions, which are discussed below, include:

- What will be the scope and point of regulation of such a program?
- What role will continuous emissions monitors play?
- How will State and regional cap and trade programs affect a potential national program?
- What will be the impact of voluntary protocols and registries?

### *Scope and Point of Regulation*

Ultimately, the scope and point of regulation of a potential trading program could have an impact on the types of MRV systems developed. To the extent that a program might just cover the electric power sector, it is likely that the MRV system would build upon the existing model used in the SO<sub>2</sub> and NO<sub>x</sub> programs. As noted, most electric power sources already report their CO<sub>2</sub> emissions to EPA.

The details of a potential MRV system are less certain in legislative proposals that address sectors beyond electric power. Specifically, two legislative proposals—the McCain-Lieberman Bill and a proposal by Senator Bingaman—are for economy-wide programs that would cover multiple sectors. In the case of McCain-Lieberman, emissions from the electric power and industrial sectors are regulated “downstream” (i.e., at the smokestack) while emissions from the transport sector are regulated “upstream” based on the emissions potential of fuels processed by oil refineries. In contrast, under the Bingaman proposal, the point of regulation is entirely upstream at fuel producers, processors or transporters (e.g., natural gas pipelines). Thus, new protocols for monitoring, verifying and reporting the emissions potential from upstream sources and the emissions from some downstream industrial sectors might be necessary.<sup>53</sup>

### *Use of CEMs*

CEM’s are a cornerstone of the emissions monitoring system in US conventional pollution trading programs. But what factors and considerations will determine their use in a potential greenhouse gas trading program? First, as the discussion above notes, one important factor will be the point of regulation. For example, if the point of regulation is entirely upstream, CEMs would not be used at all. CEMs would only be an option in trading programs where some or all of the point of regulation is downstream. Second, it is important to note that the existing CO<sub>2</sub> reporting requirement for electric power facilities does not *require* CEMs and allows facilities to choose alternative methods. Approximately 40% of units that report CO<sub>2</sub> emissions to US EPA use CEMs and 60% use alternative methods. This represents about 87% of CO<sub>2</sub> emissions that are measured with CEMs. Most of the units that use CO<sub>2</sub> CEMs are coal-fired units, while oil and gas-fired units generally use alternative methods. Third, to the extent that sources already use CEMs (i.e., in the power sector), there may be a strong incentive to continue to use those existing systems. For example, Regional Greenhouse Gas Initiative (RGGI) states have proposed using the existing reporting

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<sup>53</sup> Note that because of the jurisdictions of the Senate committees responsible for these bills, there are different administrative agencies involved in developing guidelines or operating the programs. Under the McCain-Lieberman proposal, the program would be administered by US EPA but emissions monitoring guidelines would be developed by the Department of Commerce. Under the Bingaman proposal, the US Department of Energy would have overall responsibility for the program, including the development of MRV guidelines.

system for CO<sub>2</sub> (i.e., CEMs for some units and alternative methods for others). This proposal has received support from industry stakeholders, who presumably do not want to develop a new or additional monitoring and reporting system. (Northeast Greenhouse Gas Coalition, 2004). In contrast, the motivation to use CEMs may not be as strong for facilities outside of the power sector since they are not currently reporting CO<sub>2</sub> to EPA. In addition, for some sectors with process or fugitive emissions, using CEMs may not be feasible or practical.

#### *Impacts of State and Regional Programs*

A further uncertainty about the design of future US GHG trading programs is the impact of state and regional programs that are now under development. The most advanced of these efforts is the RGGI, a cap and trade program under development by nine states in the northeastern and mid-Atlantic United States. Initially, the program will address CO<sub>2</sub> emissions from the electric power sector. However, the program may be expanded to include additional sectors and GHGs. In general, the RGGI program has proposed to use compliance and enforcement structures similar to those used in the US NO<sub>x</sub> trading program. In addition, as noted above, the program has proposed using CO<sub>2</sub> data currently reported to EPA.

West Coast states may develop a different model for a cap-and-trade program. Concerns about addressing imports of power from outside the state have led some stakeholders to advocate design approaches that focus on the distribution of electric power rather than generation. For example, an advisory group to the Governor of Oregon has recommended a tradable carbon content standard for power consumed in the state, which would take power imports into account. (Governors Advisory Group 2004). California is considering a proposal to allocate allowances to load-serving entities, which would be required to hold allowances to cover the emissions of the electric power they distribute (CCAP 2005). Such a program might require some sort of program for monitoring or estimating emissions associated with power imported from outside the state. How these programs might address MRV and other compliance and enforcement issues has not yet been determined.

#### *Impacts of Voluntary Efforts*

A final uncertainty is the impact of voluntary greenhouse gas reporting protocols and registries on a potential mandatory US weighting national system. For example, more than ten states have adopted or are in the process of adopting voluntary registries for greenhouse gas emissions (PPI 2003). Most notable is the California Climate Action Registry Program, which uses a greenhouse gas reporting protocol based on the WRI/WBCSD reporting protocol. There are also Federal greenhouse gas reporting and registry programs. Under the EPA Climate Leaders Programs, companies develop comprehensive greenhouse gas inventories, set corporate emission reduction targets, and report annually their emissions and progress towards reaching their targets. The program's reporting protocol is based on the WRI/WBCSD protocol and it requires entity-wide reporting. Under the Voluntary Reporting of Greenhouse Gases Program, established by Section 1605(b) of the Energy Policy Act of 1992, organizations and individuals who have reduced their emissions may record their accomplishments and publicize their actions. This program encourages entity-wide reporting but provides also flexibility in defining the reporting entity.

Voluntary reporting schemes and registries have a number of benefits, including helping corporations understand the scope of their emissions and the possible mitigation measures that they might take. Voluntary reporting programs may also raise awareness of the climate change issue and highlight the actions of companies who are leaders in reducing their emissions.

Several aspects of voluntary protocols may require revision or elaboration to be adequate for mandatory trading programs. This is because there is an inherent tension in voluntary protocols, which must balance the desire to encourage participation with the costs associated with a rigorous emissions reporting program. If measurement and reporting requirements are too rigorous and costly, there will be few participants. Conversely, if program reporting restrictions are too lenient, the resulting emissions data may not be an appropriate foundation for a future mandatory program. In addition, some voluntary registries and protocols require reporting at the company-wide level rather than the facility level. While this is appropriate for a voluntary program that tracks a corporate emissions goal, it is less useful for a sector wide or economy wide mandatory trading program, where it is important to carefully track emissions at the facility level. Existing conventional air pollution control programs require emissions reporting at the unit or facility level, in part because of the complexity of tracking shifts in corporate structure.

Nevertheless, experimentation with voluntary protocols by industry may lead to the development of better emissions estimation methodologies. This may be particularly true for sectors such as iron and steel, where emissions monitoring or estimation is less than straightforward. This experience would certainly inform the development of future US mandatory guidelines for emissions monitoring.

### 3.3.2. *Compliance Challenges for the EU*

Within the EU ETS, the major challenge is to ensure consistent implementation of MRV across member states. Effective implementation of MRV is an integral part of enforcement and deterrence, preconditions for compliance. Achieving consistency – a permanent challenge for the EU – requires creating similar procedures across member states, which would be comparable to creating an internal market for MRV. Such a market would offer considerable efficiency gains and ensure a level playing field, i.e. allow for undistorted competition within the EU internal market.

Within the EU, this is typically approached in a “learning by doing” mode, where different member states experiment with different national responses to EU framework legislation. In the absence of a central federal enforcement agency, the European Commission provides guidance while at the same time ensures compliance with laws. Non-compliance will result in member states being brought to the European Courts. Member states supported by the European Commission share experiences and eventually identify best practices, which member states might want to apply. In addition, there are numerous multi-stakeholder initiatives that attempt to incrementally harmonize procedures (“soft harmonization”).<sup>54</sup>

The challenge for the EU and its member states is to transpose the MRV provisions into national legislation, taking into account the national institutional landscape and legal circumstances (including established practices), while at the same time ensuring a minimum degree of harmonization across member states. The EU has looked to the US OTC NO<sub>x</sub> budget program, which is more decentralized than the SO<sub>2</sub> program, the EU is largely on its own in developing a decentralized model.

#### *Principle Challenges*

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<sup>54</sup> See for a more detailed Egenhofer and Fujiwara (2005), *Reviewing the EU Emissions Trading Scheme – Priorities for Short-Term Implementation of the Second Round of allocation. Part I*. CEPS TASK FORCE REPORT No. 56, pp. 27; available at [http://www.ceps.be/files/TFReport\\_EU\\_ETS\\_Part\\_I.pdf](http://www.ceps.be/files/TFReport_EU_ETS_Part_I.pdf).

A first challenge for the EU is to clarify institutional responsibilities. Currently, responsibilities for MRV in the EU and its member states lie with the EC, 25 member states, more than 150 Competent Authorities, around 11,500 installations, a yet uncertain number of verifiers and accreditation bodies. While the EU ETS Directive and subsequent legislation in principle have assigned responsibilities, in practice the boundaries might sometimes be blurred. The critical intersections are: European Commission and member states, Competent Authorities and companies, verifiers, and accreditation bodies.

A second issue relates to member state implementation. This starts with the quality of the member state permit, which includes the MRV protocol requirements. There is a possibility that member states' rules will differ as to the nature, frequency, and depth of inspections to be carried out. It is also likely that member states will differ in the rigor with which they enforce these requirements. Too many differences between member states are likely to affect the level playing field of competing companies and, at the extreme, may lead to gaming. There is also a risk that, if flexibility leads to inconsistencies within or between member states, national regulators may extend their intervention.

A third challenge relates to verifiers. Accreditation requires that verifiers have demonstrated competence and have shown to be qualified. Once the first emissions reports in March 2006 will be available, there will be data to assess competence. For the initial phase, how to assess competence is still an open question, as member states may apply different criteria. But major diversity in stringency of accreditation is likely to affect credibility of the EU ETS. As verifiers play a central role in the MRV in the EU ETS, uniformity of accreditation is a critical element for the first round of compliance and beyond.

#### *Initial Responses*

Some of the challenges, such as the initial competence assessment of verifiers and jurisdiction issues for different institutions, are typical issues for a new and ambitious scheme that is breaking new ground. They will be addressed during the first round of compliance through different processes. The Working Group III sub-committee on the Comitology Committee will address some of these issues, but its mandate is not to achieve full harmonization. Rather, it is to ensure that member state implementation is in line with EU law. There are also complementary initiatives aiming at voluntary harmonization by member states. Such voluntary harmonization initiatives in many cases seek the active involvement of stakeholders.

There has already been progress on further harmonization of verification and accreditation standards and procedures. This includes the application of the European Co-operation (EA) for Accreditation's *Guidance for Recognition of Verification Bodies under EU ETS Directive*.<sup>55</sup> Many member states are looking to use this document as the basis for setting up accreditation schemes for verification bodies, particularly those that are members of the EA. In addition, member states are currently developing a common Verification Resource Model, which covers both a model for GHG verification procedures and the principle elements of the verification framework. This Verification Resource Model is in line with the requirements developed by the EA in its guidance note for recognition of verification bodies under the EU ETS Directive. Competent Authorities are encouraged to use it to self-assess its situation. A EU-wide Verification Resource Centre will assist CAs in their verification exercise. In addition, focus groups with interested representatives from member states and CAs are about to be launched on the following issues: mutual recognition of verifiers;

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<sup>55</sup> Document EA 6/03, published by EA (European Co-operation for Accreditation), March 2005; [www.european-accreditation.org](http://www.european-accreditation.org).

exchange of best practices in running ETS verification; risk analysis. The framework is completed by EU ETS verification electronic forum and a network of GHGs verification national focal.

In the future, the EU could establish a common accreditation body that is responsible for accreditation of verifiers on an EU-wide basis. This would have obvious advantages related to consistency and uniformity of accreditation within the EU. The feasibility of creating a common EU accreditation body as a real political option is unclear but remains unlikely unless the European Commission takes a lead on this. An alternative option is that accreditation bodies in all EU member states follow similar rules for accreditation. Some member states are already allowing mutual recognition,<sup>56</sup> but may still carry out some form of surveillance of verification bodies when they work in another member states for the first time (e.g. UKAS). Ultimately, such an approach could allow for "mutual recognition" of accredited bodies from one EU member state to another.

### *Cost Considerations*

While initial focus of MRV will remain on implementation and capacity building, more recently, cost considerations have risen on the agenda. As one of the promises of the EU ETS has been cost-effectiveness, the EU, member states, and stakeholders monitor costs and identify areas where costs can be reduced. One such area is verification. There are differences in verification and accreditation of verifiers not only between the 25 member states but within some member states, such as Belgium and Spain. This drives up costs and reduces transparency for international companies wishing to apply uniform monitoring and reporting procedures for one verifier throughout the EU.<sup>57</sup> Some estimates assume that third party verification may result in US \$120 million annual costs in the EU.<sup>58</sup>

It has been argued that the inclusion of small installations into the EU ETS leads to high administrative costs for both governments and the covered sources, compared to the environmental benefit<sup>59</sup>. Typically for small installations that emit less than 25,000 ton of CO<sub>2</sub>, additional costs from monitoring and reporting can amount to more than € 2.5 per tons of CO<sub>2</sub>.<sup>60</sup> Figures for the UK have proven to be even higher, especially for installations emitting less than 5.000 tCO<sub>2</sub> p.a.. At the same time emissions from small installations may not be very important.<sup>61</sup> Therefore, one of the principle priorities of the revision of the ETS MRG is cost-efficiency and more specifically, to lighten the administrative burden for small installations.

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<sup>56</sup> "Mutual recognition" is a central element of the EU's internal market for goods. It describes that fact that EU member states are required to recognize marketing authorization issued in another member state as long as the product complies with EU minimum health and safety standards ("essential requirements"). In services, the validity of the mutual recognition principle remains controversial.

<sup>57</sup> For international verifiers wishing to serve their international customers it can mean up to between 40 and 50 accreditations to different schemes with increased cost and reduced availability of verifiers in the market.

<sup>58</sup> This assumes \$10 thousand per installation and more than 12,000 installations (Client Alert by Latham & Watkins, Bulletin No. 423, 12/13/2004)

<sup>59</sup> Egenhofer and Fujiwara, 2005, *op. cit.*

<sup>60</sup> Dutch Advisory Board on Administrative Burdens.

<sup>61</sup> For example, excluding installations with emissions lower than 10,000 tonnes CO<sub>2</sub>/year would mean to reduce the number of participants in the EU by 32% (or about 3400 participants), but decrease emissions coverage in the ETS by only 1%. Excluding installations under 25,000 tonnes CO<sub>2</sub>/year would reduce the total number of participants dramatically (-55%), while reducing the included emissions by only 2.4%. Ecofys (2005), *Small Installations within the EU Emissions Trading Scheme – Summary* (authors: Ernst Worrel and Suzanne Woosen), Ecofys, Utrecht, April.

Practically speaking, the following points are under discussion: i) establishing a list of exemptions from requirements of MRG for small installations,<sup>62</sup> ii) reducing and simplifying requirements for the monitoring of biomass fuels, iii) widening scope for simplified approaches for minor sources, iv) simplifying approaches for standardized commercial fuels, v) creating differentiated requirements for the accreditation of laboratory analyses, vi) including several existing commercially relevant practices to determine production and stock data, and vii) considering the optional use of differentiated oxidation factors.

These and other options will be discussed in formal consultations between member states and the European Commission in early 2006. The MRG revision will be finalized by spring 2006.

### 3.3.3 *The Role of Performance Management: Measuring Success*

As governments continue to experiment with emissions trading systems, evaluation of the results of these systems will be increasingly important.<sup>63</sup> There has been little explicit research on how best to measure the success and performance of enforcement and compliance systems in emissions trading programs. However, there has been an effort by INECE, OECD, and several governments to develop compliance and enforcement indicators for environmental programs in general.<sup>64</sup> Work by these organizations and governments has pointed to several benefits of using performance indicators, including helping program managers understand the effectiveness of their programs and help improve environmental programs over time.<sup>65</sup>

Traditionally, environmental program administrators have used output-based indicators such as the number of enforcement cases initiated or penalties assessed because these indicators are easy to measure and are directly tied to compliance and enforcement efforts. However, these types of metrics pose a dilemma. In an ideal environmental program, one would expect high compliance and few penalties assessed. The question is whether this outcome is the result of good compliance or poor enforcement? Moreover, these types of measures are often not a good gauge of the overall success of an environmental program. Because of the shortcomings of these types of indicators, the literature suggests more sophisticated measures are

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<sup>62</sup> The proposed exemptions include reduced accuracy requirements for the emission determination, reduced requirements in respect of the quality management and accreditations for laboratory analyses, reduced requirements for the uncertainty analysis, reduced requirements for the retention of data and documents, and a higher materiality level to be applied in the verification process.

<sup>63</sup> See Kenneth J. Markowitz, Krzysztof Michalak, & Meredith Reeves, *Improving Environmental Compliance and Enforcement Through Performance Measurement: The INECE Indicators Project*, in MAKING LAW WORK: ENVIRONMENTAL COMPLIANCE & SUSTAINABLE DEVELOPMENT, 337-46 (Durwood Zaelke, Donald Kaniaru, & Eva Kružíková eds., 2005).

<sup>64</sup> OECD defines enforcement indicators as “those measurable pieces of information that inform about compliance promotion, compliance monitoring, and non-compliance response.” Environmental Compliance and Enforcement indicators are sometimes divided into two categories: output based indicators and outcome based indicators. Output based indicators are activities or services performed by a government program during a specific time period. Stahl M. (2004) Performance Indicators for Environmental Compliance and Enforcement Programs: The U.S. EPA Experience, INECE Expert Working Group on Environmental Compliance and Enforcement Indicators, at <http://inece.org/indicators/docs/StahlPaper.pdf>. These could include the number of inspections performed or the number of penalties assessed. Outcome indicators are tied to the environmental effects of a program, either interim effects such as tons of emissions reduced.

<sup>65</sup> Other benefits of performance indicators may include: helping program managers understand the relationships between program activities, such as inspections and audits, and the change in behavior or performance by the regulated community; enhancing the accountability and credibility of environmental programs with outside stakeholders; and monitoring internal operations and maximizing the efficient use of government resources. Stahl M (2003) Performance Indicators for Environmental Compliance and Enforcement Programs: The U.S. EPA Experience, presented at INECE-OECD Workshop on Environmental Compliance and Enforcement Indicators, Paris, at [http://www.inece.org/indicators/proceedings/04p\\_us.pdf](http://www.inece.org/indicators/proceedings/04p_us.pdf).

necessary to address the multiple audiences for information on program performance. For example, Stahl notes, “A combination of measures – outputs and outcomes, quantitative and qualitative, statistical and narrative, aggregated and disaggregated, national and local – is necessary . . .”<sup>66</sup>

In US trading programs, both output and outcome data is used to evaluate the performance of compliance and enforcement decisions. For example, examples of indicators include:

- the percent of sources subjected to environmental audits
- the percent availability of emissions monitors
- results of relative accuracy tests for monitors
- and the number of enforcement actions taken and penalties assessed.
- the overall compliance rate of affected sources

The programs also use a variety of outcome indicators to measure the overall effectiveness of the programs, including emissions and deposition reduced, as well as changes in the environment attributable to emission reductions. For the most part, compliance and enforcement measures are viewed as a component of the overall system, including the overall environmental results, costs and market function. A number of studies have looked at the compliance results of these programs in the context of the overall performance of the programs.<sup>67</sup>

#### 4 CONCLUSION: TOWARDS A COMMON CURRENCY

The preceding sections have highlighted the differences and similarities between the U.S. and EU approaches to MR&V in emissions trading systems. Ultimately, there may be additional variations on these models, as Canada, Japan and other countries begin to adopt domestic emissions trading systems. Given these differences in approach, what will be the best way to proceed towards a common currency?

The first step to answering this question is to understand the extent to which different approaches might lead to different results. For example, would reported emissions from a facility be significantly different with U.S. methodologies than EU methodologies? To what extent are differences procedural rather than substantive? A more technical analysis of monitoring methodologies will be necessary to answer these questions.

A second consideration will be a more general need to understand the MR&V issues that arise when different national trading programs are linked.<sup>68</sup> The ultimate laboratory for understanding these linkage issues will be the first year(s) of implementation of the EU ETS. As discussed, there is flexibility among EU

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<sup>66</sup> *Id.*

<sup>67</sup> Burtraw, D., Palmer, K., 2003. *The Paparazzi Take a Look at a Living Legend: The SO<sub>2</sub> Cap-and-Trade Program for Power Plants in the United States*. RESOURCES FOR THE FUTURE. Discussion Paper 03-15. Ellerman, AD, Joskow P, Harrison D (2003) *Emissions trading in the US: Experience, lessons, and considerations for greenhouse gases*. PEW CENTER ON GLOBAL CLIMATE CHANGE, Arlington, provide recent assessments of the SO<sub>2</sub> program. Farrell A. *Multi-lateral emissions trading: lessons from inter-state NO<sub>x</sub> trading in the United States*. ENERGY POLICY 2001;29(13):1061-1072; and Burtraw, D., Evans, D., 2003. *The Evolution of NO<sub>x</sub> Control for Coal-Fired Power Plants in the United States*. RESOURCES FOR THE FUTURE. Discussion Paper 03-23, provide an assessment of the 9 State NO<sub>x</sub> OTC program.

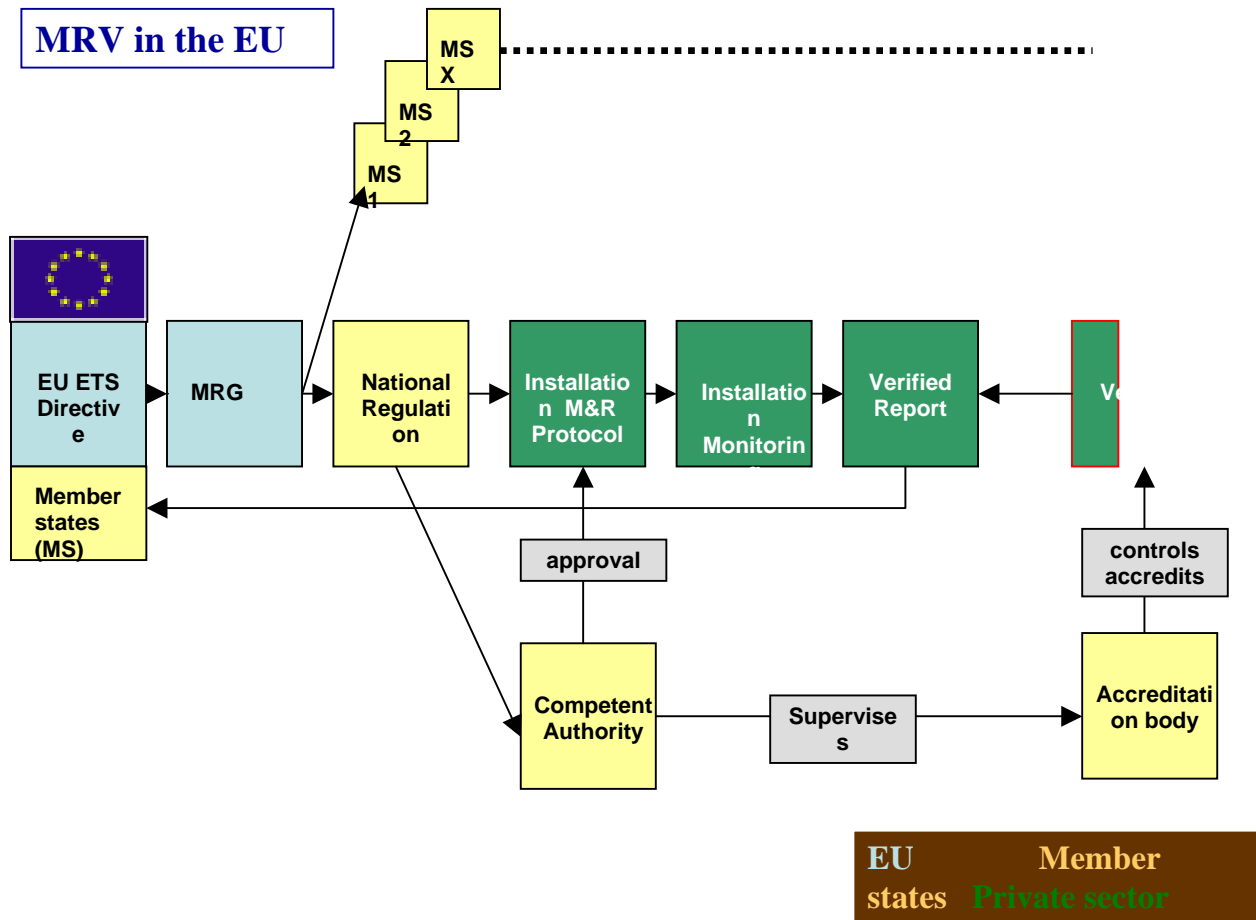
<sup>68</sup> It is important to note that in addition to MR&V issues, there are a number of additional issues that come into play when different emissions trading systems are linked. This includes relative cap stringency, trading and banking rules, and other design elements.

Members states in how they implement MR&V guidelines. Understanding the proper balance between flexibility and consistency in the EU ETS will be very useful as a test case for linking domestic systems.

Finally, further dialogue between experts is necessary to build understanding of the unique features of the EU and U.S. models. U.S. observers may need more information on how 3rd party verification actually works in an emissions trading program. For example, what will be the impacts of 3rd party verification on the administrative efficiency of the verification process? EU and Member State officials may need more information on whether the information technology based system used in the U.S. for reporting and verification will be flexible enough to meet the needs of diverse Member States. In addition, there may be questions about whether this type of approach could be applied to the wider universe of sectors and installations in the EU ETS. Ultimately, sharing detailed information about different MR&V systems will lead to better understanding of the costs and benefits of different approaches. This may be the best first step towards a common currency for emissions trading.

ANNEX I

Figure 1. Monitoring, Reporting, and Verification in the EU



MR&V in the EU ETS is based on the legally binding Guidelines for monitoring and reporting (MRG) of emissions, based on Article 14 and Annex IV of the Directive. The guidelines are adopted by the European Commission in close co-operation with member states.

The MRG are addressed to MRG are addressed to member states, which need to define monitoring methodologies for their jurisdictions. The principal methodology is the calculation of emissions by the use of emissions factors coupled with fuel use or production data.

Except Germany<sup>69</sup> all member states have decided to agree an installation-specific monitoring methodology as part of the permitting procedure. This installation installation-specific methodologies are to be submitted to the so-called Competent Authority for approval.

The MRG identifies different “tiers” of methodologies reflecting different degrees of accuracy. By default installations should use the top “tier”, except when they can prove that a methodology is impractical or cause disproportionate costs. In this case, governments can waive this obligation. US-style *continuous emissions monitors* are possible but are expected not be used.

The operator reports on the emissions as monitored according to the permit and the thereby approved monitoring methodology. The operator must ensure that emissions have been monitored according to the rules of the proposed methodology that is part of the permit and prove this through the emission report. These self-reported emissions are verified by an independent third party either a government body or more likely an accredited verifier. The verifier controls (i.e. “verifies”) whether the emissions have been monitored and reported in accordance with the approved (“validated”) methodology in the permit.

Control and accreditation of verifiers rests with the national accreditation body, which reports to the Competent Authority. As the verifier in principle has the final word in the process, it is important that the Accreditation Body for verifiers guarantees that verifiers are qualified and adequately supervised.

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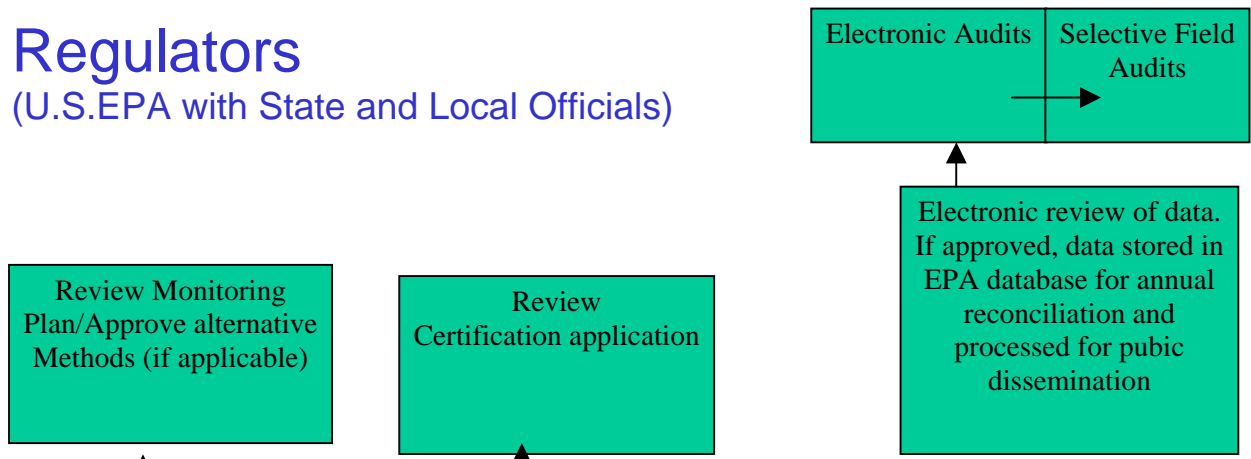
<sup>69</sup> Germany has set out the monitoring and reporting requirements in the permits by reference to general rules of the MRG.

ANNEX II

Figure 2. Monitoring, Reporting, and Verification in US Trading Programs

# MR&V in U.S. Trading Programs

**Regulators**  
(U.S.EPA with State and Local Officials)



**Industry**

### ANNEX III

**Figure 3. MRV: Differences & Similarities of US and EU Emissions Trading Schemes**

US	EU
<p><b>Monitoring:</b></p> <ul style="list-style-type: none"> <li>- SO<sub>2</sub> TP: federal (i.e. centralized) regulation based on detailed standardized rules.</li> <li>- NO<sub>x</sub> BTP: states must incorporate the same standardized federal monitoring rules in their “model rules”;</li> </ul>	<p><b>Monitoring:</b></p> <p>Broad set of guidelines give MS and installations flexibility to develop specific procedures. This is complemented by coordinated approach among MS including a network of Monitoring and Reporting focal points at national level (established).<sup>70</sup></p>
<p><b>Information Technology:</b></p> <p>Use of information technology for monitoring, reporting and verification</p>	<p><b>Information Technology:</b></p> <p>Currently developed by some member states. Experiences in some MS will be discussed in the framework of exchanging best practices</p>
<p><b>Verification:</b></p> <p>Undertaken by government with extensive electronic procedures with occasional on-site inspections</p>	<p><b>Verification:</b></p> <p>Generally third-party verification implemented by MS; no uniform standards to be applied either for verifiers or accreditation of verifiers; on-site inspection subject to MS autonomy. Common approach to verification is under construction in the light of the finalization of the 1<sup>st</sup> MR&amp;V cycle.<sup>71</sup></p>
<p><b>Administrative and Criminal Penalties:</b></p> <p>Country-wide the same</p>	<p><b>Administrative and Criminal Penalties:</b></p> <p>Responsibility** of MS but Commission receives notification of relevant MS provisions; plus “naming and shaming” of non-compliant operators</p>
<p><b>Registries:</b></p> <p>Both the SO<sub>2</sub> and NO<sub>x</sub> programs have a centralized registry administered by U.S.EPA or Allowance Tracking System (ATS) in U.S. terminology</p>	<p><b>Registries:</b></p> <p>Originally each MS has its own registry but Registry software developed by UK is licensed to 15 MS to develop jointly the Registry; Ultimately the Registry will be held by GRETA International Limited, a</p>

<sup>70</sup> The new MRG (foreseen for spring 2006 and entering into force in January 2008) might actually look more like the NO<sub>x</sub> BTP “model rules”.

<sup>71</sup> For example, the establishment of a Verification Reference Model and EU Verification Resource Center are among the tools under preparation. A network of Verification focal points at national level has been established.

	company under private law.
<b>Non-discriminatory and automatic penalties to enforce emissions cap:</b> Yes.	<b>Non-discriminatory and automatic penalties to enforce emissions cap:</b> Yes.
<b>Access to Data:</b> Data on emissions are publicly available.	<b>Access to Data:</b> Data on emissions are publicly available.

MS = EU member state

SO<sub>2</sub> TP = SO<sub>2</sub> Trading Program

NO<sub>x</sub> BTP = NO<sub>x</sub> Budget Trading Program

\* Use of information technology is increasingly increased in the EU

\*\* There is (almost) no EU competency in this area