



Review of the EU Emissions Trading Scheme – joint statement on key issues and concerns

May 2007

The EU Emissions Trading Scheme (ETS), is the most ambitious and innovative intergovernmental policy so far aimed at reducing greenhouse gas emissions. Europe is leading the way in implementing market based, cost-effective solutions to a global problem. The ETS covers nearly half of Europe's CO₂ emissions, so its success is vital to deliver the EU's targets under the Kyoto Protocol. A successful ETS could also form the cornerstone of future global agreements to fight climate change.

However, the system is being seriously undermined by a number of mistakes made during the first phase of the scheme (2005-2007) – with the result that it is currently failing to deliver real cuts in greenhouse gas emissions. Furthermore with the start of phase II (2008-2012) now only 8 months away the European Commission is still ruling on Member State plans and the jury is out on whether it will deliver substantial emissions reductions within Europe.

In the midst of this, the review of what the scheme will look like after 2012 has now commenced. Key to its success post 2012 though will be the extent to which it positively influences both operational but crucially the investment decisions of European industries. This statement sets out the key issues that the current review of the scheme must address if it is to ensure that the ETS plays a significant role in putting the EU on a low carbon trajectory. It also highlights some important concerns particularly with regards to expansion and linking.

The UK Government as one of the key advocates of the ETS has a clear role to play in driving the progressive debate on these issues and concerns forward in Europe, and in ensuring that the scheme plays a vital long term role in fighting climate change.

1. AN EU WIDE CAP, LEVEL OF AMBITION AND LONGER TERM CERTAINTY

We would advocate that future caps are set centrally at the EU level to minimise distributional impacts, and to ensure greater efficiency, transparency and fairness of the process. The level of the cap for the sectors covered by the scheme should be at least as ambitious as the 30% cut in greenhouse gas emissions by 2020 announced by the European Council in March this year.

In order to provide longer-term investment certainty for business beyond 2020 we would also propose that a 2050 target of at least an 80% cut in greenhouse gas emissions below 1990 levels is established. This could be divided into trading periods with mandatory targets, and an annual carbon budget which sets year on year reductions. We would suggest that trading periods are not longer than 5 years as this would likely result in protracted negotiations unlikely to achieve a

good result. They would also make the system inflexible in the case that faster tightening of targets is needed.

2. ALLOCATION METHODOLOGY

Future allocations for new and existing plant should be based on 100% auctioning which ensures that the full costs of carbon are factored into investment decisions. All other allocation methodologies that give allowances for free (grandfathering and benchmarking) fail to provide the non-distorting incentives needed to drive investment in cleaner technologies and fuels.

Auctioning also greatly simplifies the initial allocation process (as it gets rid of the need for complicated rules to deal with new entrant reserves and closures) and eradicates the accrual of windfall profits¹. Furthermore, when combined with a robust long term cap full auctioning also provides greater investment certainty to business.

If 100% auctioning is not deemed appropriate for phase III then as a move towards this the aviation and power sector – which are not exposed to significant international competition – should be required to purchase all of their allowances from 2013.

3. EXPANDING THE SCOPE OF THE SCHEME

The ETS was designed to tackle emissions from large industrial point sources. The focus of the review should therefore be on refining and improving its effectiveness in dealing with these rather than looking to substantially expand the scheme at this stage – particularly with regards to non-industrial sectors such as surface transport and land use.

There may, however, be scope for some considered expansion but this should be judged against the following principles:

- emitters should be large point sources – thereby ensuring enhancement of the effectiveness of the scheme at least implementation cost;
- inclusion in the scheme should positively influence behaviour and investment decisions;
- the capped entity must “own” the emissions and emissions must be able to be clearly defined, monitored and reported;
- the cost of expansion must not outweigh the abatement benefit of being included in the scheme;
- only sectors where other policies and measures such as mandatory efficiency targets or taxation are likely be less effective in reducing emissions should be considered;
- harmonisation of expansion across the EU must be possible and ensured; and
- expansion must not undermine the environmental integrity of the scheme.

¹ Indeed, the partial RIA accompanying the draft UK Government's Climate Change Bill (<http://www.defra.gov.uk/corporate/consult/climatechange-bill/ria.pdf>) states "DTI analysis has estimated that the large electricity generators gained £1.2-1.3 billion in 2005 arising from grandfathering of emission allowances under the EUETS"

Views on the inclusion of specific sectors/activities

Domestic offsets

The inclusion of domestic offsets was discussed during the negotiations of the Linking Directive. However, it was decided that for the first phase only credits from Joint Implementation (JI) and Clean Development Mechanism (CDM) projects would be allowed. We consider that domestic offset projects should continue to be excluded from the ETS for the following reasons:

- If there is significant greenhouse gas abatement potential in a sector then arguably it should be governed by a separate policy and not be used to allow emissions from the ETS sectors to grow. For future phases the emphasis must be on reducing emissions from the ETS sectors rather than expanding their access to cheap emissions reductions from other sectors.
- Ad hoc development of projects is not a particularly effective way of tackling emissions from a sector. Indeed the inclusion of domestic offset projects may be used as an excuse to delay the implementation of more focussed policies.
- Inclusion of domestic offsets may make it more complicated to determine the direct contribution of the ETS sectors to EU greenhouse gas emission reduction targets and to determine whether they are playing their fair share or not.
- There is the risk of double counting of emissions reductions.

Surface transport

We are concerned that the potential inclusion of surface transport in the ETS may be considered as a way to tackle pollution from this sector. We consider that these emissions can be more effectively dealt with by measures such as fuel standards, fuel taxes and other modal shift incentives - not by including the sector in the ETS. Three key reasons why it would not be appropriate to include surface transport in the scheme are as follows:

- Market distortions and price impacts - it is likely that the sector will be a net buyer of emission allowances rather than reducing emissions itself (as transport can cope with higher carbon prices relative to some other industrial sectors currently in the scheme). This will push up the carbon price – raising concerns over a perverse feedback loop in which weaker caps are set for other sectors unable to cope with high carbon prices – resulting in little abatement taking place as a result of the scheme.
- “Lock-in” – inclusion in the ETS is unlikely to lead to direct emissions reductions in the sector and could help to “lock in” decisions on high carbon infrastructure and behavioural choices which will be difficult or costly to reverse at a later date.
- Other measures - inclusion of road transport might be used as an excuse not to impose any stronger and more robust measures such as fuel standards and taxes that would directly address emissions from this sector or to delay the implementation of these.

In addition a decision would need to be taken over who would wear the cap – vehicle manufacturers and fuel suppliers have both been mooted as possible entities but this raises issues over ownership of emissions. Manufacturers have no control over fuel consumption and lifetime carbon emissions of the vehicle once it has been sold. Fuel suppliers have even less options as they have no control over improvements in fuel efficiency, while the option of fuel

switching is only partly available and already substantially addressed by policies to promote biofuels.

4. LINKING

Linking of the EU ETS to other schemes post 2012

We consider that developed countries must take on deeper targets, at least 30% below 1990 levels by 2020, and that some developing countries will have to contribute more, based on a set of transparent and fair criteria. This further contribution could potentially involve those countries more in the international emissions trading market through policies such as sectoral commitments or sustainable development policies and measures. Formulated carefully, such contributions would allow financial and technical transfer to key developing countries while providing industrialised countries with further means to meet domestic targets.

The United States and Australia should join the second commitment period of the Kyoto Protocol with national targets to reduce their emissions. If this does not happen then consideration could be given to the linking of the ETS to sub-national trading schemes if those schemes meet key basic criteria. In this respect we agree with the criteria in the Government's ETS issues paper² that any scheme must:

- be mandatory and set an absolute, sufficiently robust cap on emissions;
- have comparable monitoring, reporting and verification requirements;
- have comparable compliance and enforcement procedures;
- have comparable offset/project credit provisions; and
- have a similar level of stringency.

Whether or not such credits could be utilised by Kyoto countries to meet their targets post 2012 is a matter for negotiation. However, we consider that until at least a national cap and trade system is in place in these developed non-Kyoto countries - that allowances from these schemes should not be eligible for meeting EU ETS caps.

Furthermore and with reference to the complementarity principle - there must be a limit to the extent to which the ETS can utilise links with other trading schemes to meet its emission reduction targets.

Use of CDM and JI project credits

Within the ETS Member States are obliged to set limits on the number of JI/CDM credits that the sectors within the scheme will be able to buy. Despite the European Commission's attempt to assess whether the limits proposed in National Allocation Plans are in compliance with the "supplementarity" principle there are strong indications that access to project credits in phase II will be significant and constitute a far greater proportion of the emissions reductions than the principle implies. For example an assessment of the first 12 plans to be ruled on indicated that

² "EU Emissions Trading Scheme Review – Issues Paper (March 2007)" Defra,
<http://www.defra.gov.uk/environment/climatechange/trading/eu/pdf/euets-issues-paper.pdf> March 2007

approximately 85% of the emissions reductions required under the combined cap could be met with JI/CDM credits³.

Importing credits could make it cheaper for EU industry to reduce emissions. But access to significant volumes of credits from overseas could disincentivise investment in clean technology development in the EU and slow down innovation. Indeed, it could help to “lock in” decisions on high-carbon infrastructure which would have a significant impact on EU emissions for many years to come.

It is of vital importance that a robust interpretation of complementarity should be adopted and implemented in harmonised way post 2012 to ensure that the overwhelming majority of emissions reductions take place within the EU.

We are also extremely concerned that approval of a project by the CDM Executive Board does not currently guarantee additionality and that sustainable development is often overlooked. Indeed recent media coverage has fuelled NGOs increasing concerns around these issues⁴.

To ensure that projects really are additional, have a positive sustainable development impact, and contribute towards a drive towards a low carbon economy - we recommend that in the future the use of project credits within the ETS is limited to those certified by the Gold Standard⁵.

5. COMPLIANCE – VERIFICATION, MONITORING AND PENALITES

The independent verification of each installation’s annual emissions is one of the key foundations of the credibility of the ETS. There needs to be uniformity in verification, and a harmonised system for the accreditation of verifiers across Member States. Transparency needs to be greatly improved, and help must be given to countries where there may be a lack of funds to ensure accurate verification of data. As a minimum the penalty level must stay at €100/tonne going forward.

³ ENDS Europe Daily 2252, 31 January 2007 “*Tough carbon trading caps “cheaper in the long run”*”

⁴ See the Channel 4 News report from February 2007 “Carbon trading not cutting CO₂”

(http://www.channel4.com/news/articles/business_money/carbon+trading+not+cutting+co2/191945#fold) and a series of articles in the Financial Times in April/May 2007 (<http://www.ft.com/indepth/carbontrading>)

⁵ <http://www.cdmgoldstandard.org>. The Gold Standard is an independent, transparent, internationally recognised benchmark for “high quality” carbon offset projects. This standard is restricted to renewable energy and end use efficiency projects, requires projects follow a conservative interpretation of the UNFCCC-additionality test and to provide evidence by a UNFCCC-accredited independent third party that they are making a real contribution to sustainable development.