

EMISSIONS TRADING - OBJECTIVES AND OPERATION

**Dr. Joachim Ehrenberg, Head of Environmental Aspects of Enterprise Policy,
European Commission**

Introduction

Based on scientific results and conclusions it has been widely accepted that climate change is one of the most important global challenges. This challenge has not been left without response by the world community and the United Nations Framework Convention on Climate Change in 1992 as well as the Kyoto Protocol in 1997 have been the results of that response.

Up to now 122 parties, responsible for 44.2% of greenhouse gas emissions from parties to the convention have ratified the protocol, still insufficient to make the protocol come into force (for which a majority of 55% is necessary) but nevertheless it is a powerful signal that a clear majority of countries would like to undertake action to combat climate change of anthropogenic origin.

Ever since the Kyoto protocol was negotiated the European Union was determined to take the lead in the international fight against climate change and that was underlined in May 2002 when the Union and its Member States, as the first large industrial region, ratified the Kyoto protocol through a Council Decision.

However, already in 2000 the European Commission had set up its European Climate Change Programme (ECCP), which essentially was a year long stakeholder consultation process and a forum where ideas on how to implement the Kyoto requirements and instruments were discussed.

The Commission fully recognised the importance of emissions trading as an essential instrument that the Kyoto protocol provides for and to this effect published a green book in 2000. Meeting emission reductions targets without damaging the competitiveness of European industry is the creed of the Union as it pursues both the objectives of the Kyoto protocol and of the Lisbon process, by which the Union endeavours to become by 2010 one of the most competitive regions of the world. It is in the nature of emissions trading that it has the potential to make a significant contribution to these combined objectives.

In 2001, the European Commission made a proposal for a Directive on a European emissions trading scheme and during the following two years Member States and the European Parliament discussed the matter in all its details. Final agreement and adoption was reached in summer 2003 and ever since Member States were and still are preparing for the emissions trading scheme to start in January 2005.

The concept of emissions trading

The concept of the European emissions trading scheme is that of a "cap and trading" scheme. Installations emitting greenhouse gases in selected industries will receive allowances for their emissions in a given period. The number of allowances allocated will be less than the volume of emissions and, in order to be in compliance with the Directive, the operator of each installation must hold at the end of each year sufficient allowances to cover for the annual emissions thereof. Therefore there is a need for the operators to either reduce emissions or buy additional emission allowances from someone who has reduced emissions more than strictly necessary. The price of the allowances will reflect emissions mitigation costs and market forces should ensure that those with the lowest costs would make

available allowances for sale, thereby helping to reduce their own costs and making compliance of those with higher mitigation costs less expensive. Those operators not complying will be liable to pay fines of €40/tonne of CO₂ during the first phase of the scheme (2005-2007), rising to €100/tonne in the second phase (2008-2012). These penalties do not exempt any non-complier from meeting his obligation to hold sufficient allowances and the outstanding obligation will have to be met in the next year.

Under the scheme, each natural or legal person can trade, and “pooling” between operators of a sector will be possible. Although trading will initially be restricted to the EU, the scheme was developed with international compatibility in mind, and links with other trading schemes are expected. There will be annual monitoring reports by operators, and annual reports by Member States to the Commission, which will produce a synthesis report each year.

The national allocation plans

The emissions trading Directive requires each Member State before each trading phase to devise a plan on how allowances will be allocated to all the installations under the scheme. This National Allocation Plan (NAP) has to be notified to the European Commission for assessment and “ex-ante” approval. The assessment will check accordance with the allocation criteria of Annex III of the Directive as well as with relevant European Treaty provisions.

The Annex III criteria include (a) consistency between the allocation of allowances and the overall national climate change programme to reach the Member State’s Kyoto target; (b) consistency with other Community legislative and policy instruments that have an effect on greenhouse gas emissions; and (c) information on how competitive issues between companies and sectors, in particular with regard to countries outside the EU, have been taken into account.

The emissions trading sector will make a contribution to Member State’s overall emission reduction objective which is shown in the table below. However, other sectors also need to participate in this effort. A Member State’s contribution to the EU’s overall 8% Kyoto target of emissions reductions has been agreed in the EU burden sharing commitment which has become legally binding.

MEMBER STATES' CONTRIBUTIONS TO THE 8% TARGET	
Austria	- 13%
Belgium	- 7.5%
Denmark	- 21%
Finland	0%
France	0%
Germany	- 21%
Greece	+ 25%
Ireland	+ 13%
Italy	- 6.5%
Luxembourg	- 28%
Netherlands	- 6%
Portugal	+ 27%
Spain	+ 15%
Sweden	+ 4%
United Kingdom	- 12.5%

Costs of Kyoto

Scope and sectors affected

It is estimated that the first phase of the emissions trading scheme will impact several thousand installations across the EU, including the new Member States. Between them, these account for nearly half of the EU's total carbon dioxide emissions.

Companies within a number of sectors will be affected, namely electricity generators and producers of iron and steel, glass, cement, pottery and bricks, along with any other industrial combustion plants exceeding 20MW.

Allowances will be allocated on an installation, and not a company, basis – and an operator of an installation must apply for a permit to run the installation before he can receive allowances. Any installation without such a permit on 1 January 05 will be treated as a new entrant, for which Member States must devise specific provisions that could result in that those operators may have to buy allowances on the market.

Cost and benefits

Emissions trading should reduce compliance costs. Nevertheless, the European Union's fight against climate change will not come without a price, although it is also true that in the longer run there might also be a price for inaction.

It is difficult to give firm figures for the costs of compliance with the EU Kyoto target (estimates range between 0.06% and about 1% of annual GDP), but according to the European Commission the use of emissions trading would give rise to savings of about 35% of these costs.

Most of the savings will be accrued in the energy production and that might have a knock-on effect on electricity prices. Energy-intensive manufacturing sectors such as steel, pulp and paper, cement, glass have in the past already reduced emissions in order to lower energy costs, face tough international pressure and are likely to have less scope for further emission reductions.

This is notwithstanding the possibility that companies moving early to develop, patent and implement the necessary technology to reduce emissions or produce alternative forms of energy may expect in the medium term a competitive advantage. It is important that emissions trading facilitates these technological developments and does not hinder them, such as to more and more decouple the emissions of greenhouse gases from economic activities.

New Member States

By the start of the first phase of the emissions trading scheme, the EU will have expanded to incorporate ten new countries (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia). The new Member States will fully participate in emissions trading but are not actually part of the "EU bubble" within which the burden sharing objectives have to be achieved. They will have to reach their own reduction targets as indicated by the Kyoto protocol.

However, industry in the "new" Member States will probably experience lesser demands for emission reductions compared to their counterparts in the "old" Member States because their collective emissions are currently about one-third under their 1990 level – the Kyoto reference year – and therefore they are under no pressure to reduce even further.

Potentially it is therefore possible that the “new” members of the EU could be a source of surplus allowances to be sold to “old” Member States, thereby influencing the trading price of allowances. But that will much depend on their national allocation plans and it might be that their governments are rather conservative in allocating allowances so as to maintain flexibility for later stages if and when economic growth has led to a rise of emissions as has already been observed in Slovenia for instance.

Next steps

Currently Member States are in the process of notifying their national allocation plans, the Commission will assess them and by 30 September 2004 operators of installations will receive information from competent authorities in Member States about their final allocation of allowances for the period 2005-2007. Once trading starts Member States and the Commission will carefully observe the market and any transactions, also by means of a harmonised transaction log details of which are to be finalised by this summer.

Gathering experience with the scheme will be the basis for Member States’ reports to the Commission and in particular for the Commission’s review of the scheme in mid 2006. By then questions on the future scope, be it the participating industry or the type of greenhouse gases included might have to be addressed as well as any other provisions of the Directive that might have given rise for concern. The aim is to learn from experience and to optimise the emissions trading system in a sustainable manner for the second period 2008-2012 in which the Union and its Member States have to deliver on their Kyoto commitment.

Moreover, it is conceivable that by then other world regions could have developed their trading scheme and that they might be linked to the European scheme. With the agreement between the European institutions on a linkage between the emissions trading scheme and the other Kyoto mechanisms, JI/CDM, the Union has already prepared the grounds for an opening up of the scheme towards non-EU countries.

Conclusions

The European emissions trading scheme must be seen as an instrument enabling the Union to comply cost-effectively with its Kyoto commitment – it is not itself the objective.

With the introduction of emissions trading to reduce greenhouse gas emissions the Union has entered new territory and this may present risks, but also opportunities. Implemented wisely by taking account of all the aspects of sustainability the European Union and its industry might benefit from being an early mover, giving it a competitive advantage if and when a global emissions trading system becomes a reality.

However, it remains important to start off on the right foot and keep a proper balance between the environmental and economic dimensions of the problem. This is in the best spirit of the Union’s commitment to the principle of sustainable development and would best contribute to reaching the Unions double objectives: complying with Kyoto and succeeding in the Lisbon process.

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