

# A review of the EU Emissions Trading Scheme and criteria for future success

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The EU ETS officially started on 1 January 2005. Andrei Marcu, President of the International Emissions Trading Association, argues that the priority now is to demonstrate that the cap and trade system can deliver a credible reduction in CO<sub>2</sub> emissions while ensuring that the EU remains competitive.

## Setting the scene

The EU ETS has become the focus for the global debate between those advocating different approaches to addressing climate change. Therefore, a lot hangs on the success or failure of the Scheme. We must therefore be able to define how the Scheme should be measured. We must not be afraid to learn from the current 2005–7 phase in order to improve its performance in the 2008–12 period and beyond.

## Success criteria

How do we define the success of the EU ETS? Its objectives are clearly environmental, but its success will depend on more than meeting these objectives. This means helping the EU meet its targets under the Kyoto Protocol, while at the same time addressing the EU's 'Lisbon Agenda' on competitiveness.

In essence, the success of the EU ETS will rest on whether it can deliver price discovery, put a price on a tonne of CO<sub>2</sub> reduction, provide price signals for the development and deployment of low carbon technologies, and enable the EU to move forward on the path to a low carbon-intensity economy.

An additional criterion for judging the success of this approach is the vote of confidence that it will/will not receive from society at large, in Europe and elsewhere. Since this is a regulated market its license to operate is one that society has granted and can easily withdraw. Poor functioning of this market, including real or perceived

abuses, the credibility of environmental delivery, and the risk of significant price disruptions on economic performance will affect the outcome.

On all these issues it is too early to pass judgement. However, having gone through the experience of the National Allocation Plans (NAPs), and the first months of operation of the ETS, we have learned some valuable lessons for the 2006 review, which can be used by others around the world who are in the process of considering moving in the same direction.

## Viability of National Allocation Plans (NAPs)

The Kyoto EU target and the burden sharing agreement were difficult political processes. The world has moved on, and the positive realities of economic growth have translated into even more difficult CO<sub>2</sub> emissions reduction targets for some Member States (see Figure 1). What is important for this market approach is the contribution that Member States are asking the sectors covered by the EU ETS to make. So far we only know the allocation for the first EU ETS period, 2005–7.

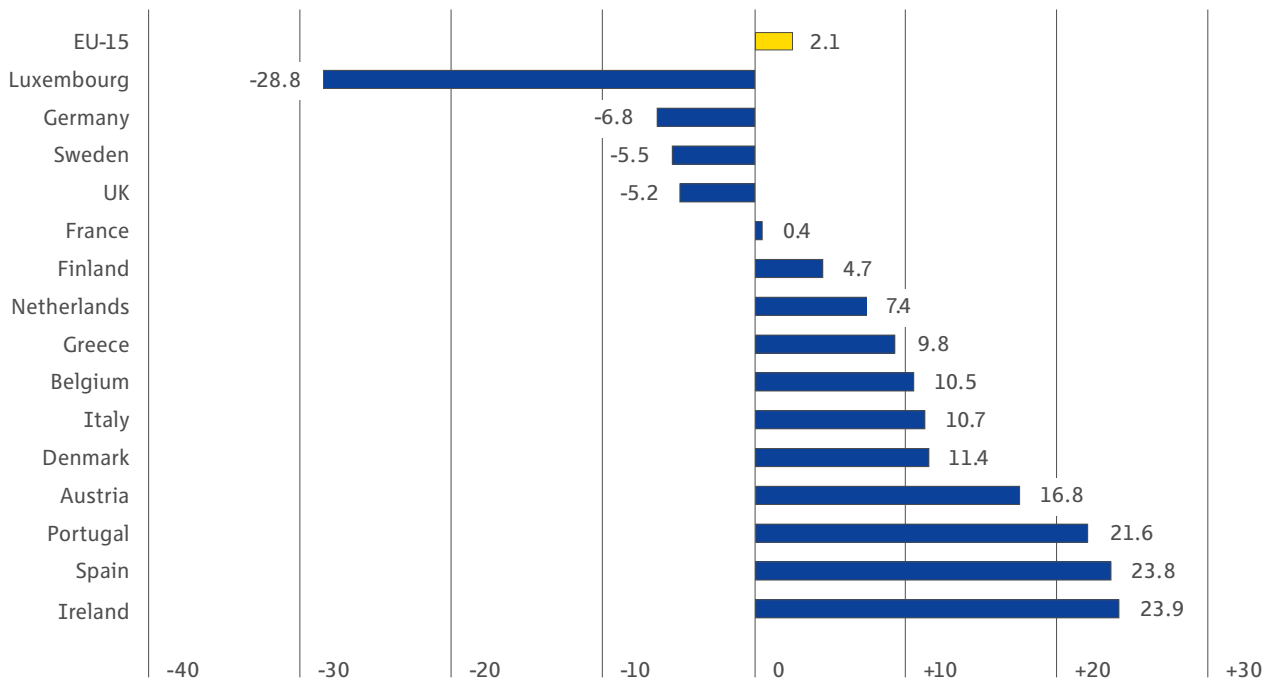
Twenty-two NAPs have been approved by the European Commission, some of them with substantial changes. At the time of writing, three NAPs still require approval – Italy, Greece and the Czech Republic. In some cases the NAP process has led to threats of legal action against the EC (e.g. the UK, Germany, Slovakia and, most recently, Poland).

A number of issues have emerged from the NAP process that may affect the ultimate success of the EU ETS. First, is the extent to which the NAPs will help meet the Kyoto targets.

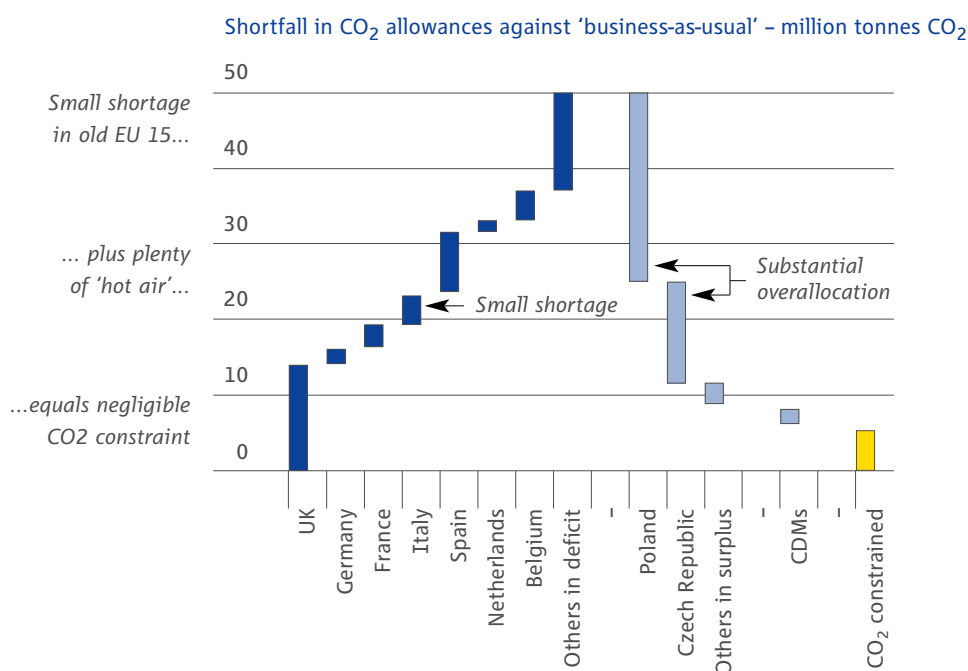
The NAPs have been criticised as being 'generous' and not making enough of a contribution towards meeting the Kyoto targets. There is some truth in this, even though the EC has, in some cases, moved to ensure that there was no over-allocation. The total cuts amount to about 3% of the proposals, or about 188 million tonnes over three years.

The graph below (see Figure 2), not adjusted for the recent ruling on the Polish NAP, shows the expected shortages during the 2005–7 period, which are not very significant. However, the Kyoto targets loom ahead and Member States will have to move in an aggressive way during the second allocation period of 2008–12 to ensure that NAPs contribute in an effective way towards meeting international obligations.

Even if Member States achieve significant reductions in non-traded sectors, large CO<sub>2</sub> reductions will be needed in the trading economy. In this context, the key question is: are NAPs realistic and what will be the impact of trying to meet these objectives in a more abrupt manner in the 2008–12 period?

**Figure 1 – Percentage points above (+) or below (-) linear target path****Figure 2 – Will Europe be CO<sub>2</sub>-constrained?**

Comparison of NAPs versus 'business-as-usual' (basis is submitted NAPs).



Source: Dresdner Kleinwort Wasserstein

Figure 3 shows what will need to be done during the second allocation period. Given the level of Clean Development Mechanism (CDM) purchases by Member States and the production levels of the CDM, we may expect shortages that may translate into significant price increases as we get into the 2008–12 period.

### Impact on competition

Given the Lisbon agenda, the EU ETS has raised serious concerns within European industry regarding its competitive position, especially for those sectors that are exposed to global competition: pulp and paper, iron and steel, aluminium, etc. The energy intensive industry continues to raise this as a serious matter as it feels that it will be affected both by the cost of allowances as well as the price of power, which they believe will reflect the opportunity cost for EU Allowance Units (EAUs). With the short experience of the EU ETS, combined with the long investment cycles of these sectors, it is impossible to make a final judgement on this issue. In this context, the basis

for the NAPs is being questioned for the second allocation period and benchmarking on a sectoral basis is seen by some as a better way forward, certainly if the alternative is auctioning.

Another aspect of NAPs that could affect the success of the EU ETS is the consistency in allocation between Member States. This may not affect environmental performance and greenhouse gas (GHG) market functioning, but it has the ability to affect the functioning of the single market within the EU. DG Competition has indicated that only gross distortion of the single market would bring action. As a deliberate strategy to obtain Member States' support, the EC proposed considerable flexibility in how allocation is done. This has allowed Member States to interpret the criteria in Annex 3 of the agreement rather differently. Similarly, treatment of new entrants and plant closure have also received a non-harmonised approach, which has led to concerns regarding asset management and rationalisation processes in sectors covered

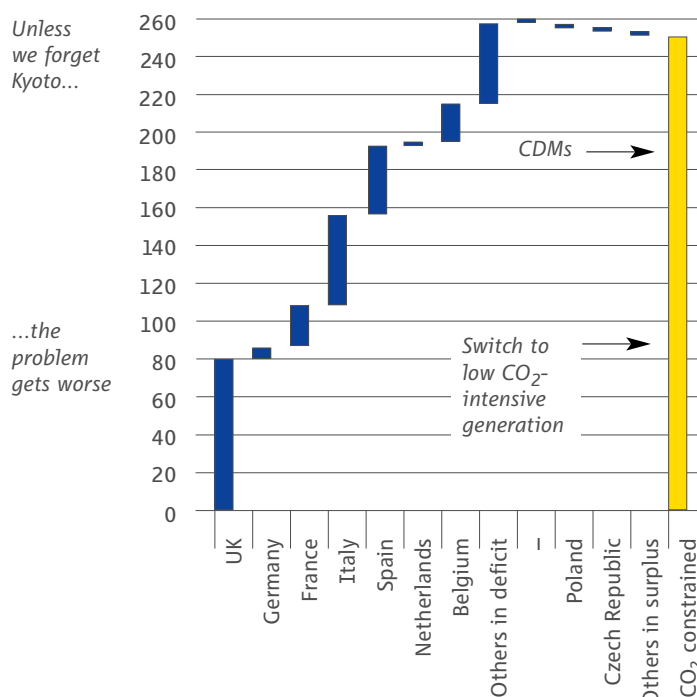
by the EU ETS. So far, there is anecdotal evidence to suggest that there are reasons for concern but no serious study has been undertaken to ascertain whether this represents a level of materiality.

NAPs should, in this purely regulatory market, create the shortages that will ensure that trading takes place and that a vibrant emissions trading market emerges. The fear has been expressed that, given that no real shortages were created by Member States, prices will collapse and trading activity will be insignificant.

**Figure 3 – Will CO<sub>2</sub> allowance prices go up?**

*Tighter constraint by 2008–12 – less scope for imaginative allocations?*

Extent of CO<sub>2</sub> constraint across Europe – million tonnes per year 2008–12.



### But there is competition for CDMs:

Government funded purchases of CDM/JIs  
Over 2008–12  
mt/year

Austria	7.0
Belgium	3.5
Denmark	3.7
Ireland	3.7
Netherlands	20.0
Portugal	5.1
Spain	20
<b>Total from approved NAPs</b>	<b>63.0</b>
Italy	55
<b>Total</b>	<b>118.0</b>

### The operation of the emissions trading market

The market is simply too young to judge the outcome at this stage. We have not yet arrived at the first review period, which will take place in 2006. Another key date is December of each year, widely used by the trading community as the contract delivery date. Based on what we have seen in the market so far, there is a significant increase in activity, with the market reacting to fundamentals and significant cross-commodity correlation. Figure 4 shows volumes and prices for the last few months. The market has reacted to weather and related commodity fluctuations, especially energy prices. Lot sizes have also increased, from 5,000–10,000 to 50,000 and higher.

Important ingredients were recent NAP adjustments with strong reaction on the down side from the UK supplemental allocation of 20 million tonnes and sharp increases after the EC's cuts in the Polish NAP.

A number of exchanges, five at the current count, are being set up. The market is operating, to some degree, as a retail and wholesale market, with probably around 30–40 significant players, with a growing number of entrants, especially in the energy sector and amongst financial institutions. It is expected that the great majority of installations covered by the EU ETS will function as a retail market, with a few trades every year, mainly for compliance purposes.

There are three master contracts currently being used by market participants – ISDA, EFET and IETA – and substantial effort has been made to harmonise them. Currently, we are witnessing forward trading only but, with the entry into operation of all the registries and the availability of EAUs in registries, it is expected that a strong spot market will develop.

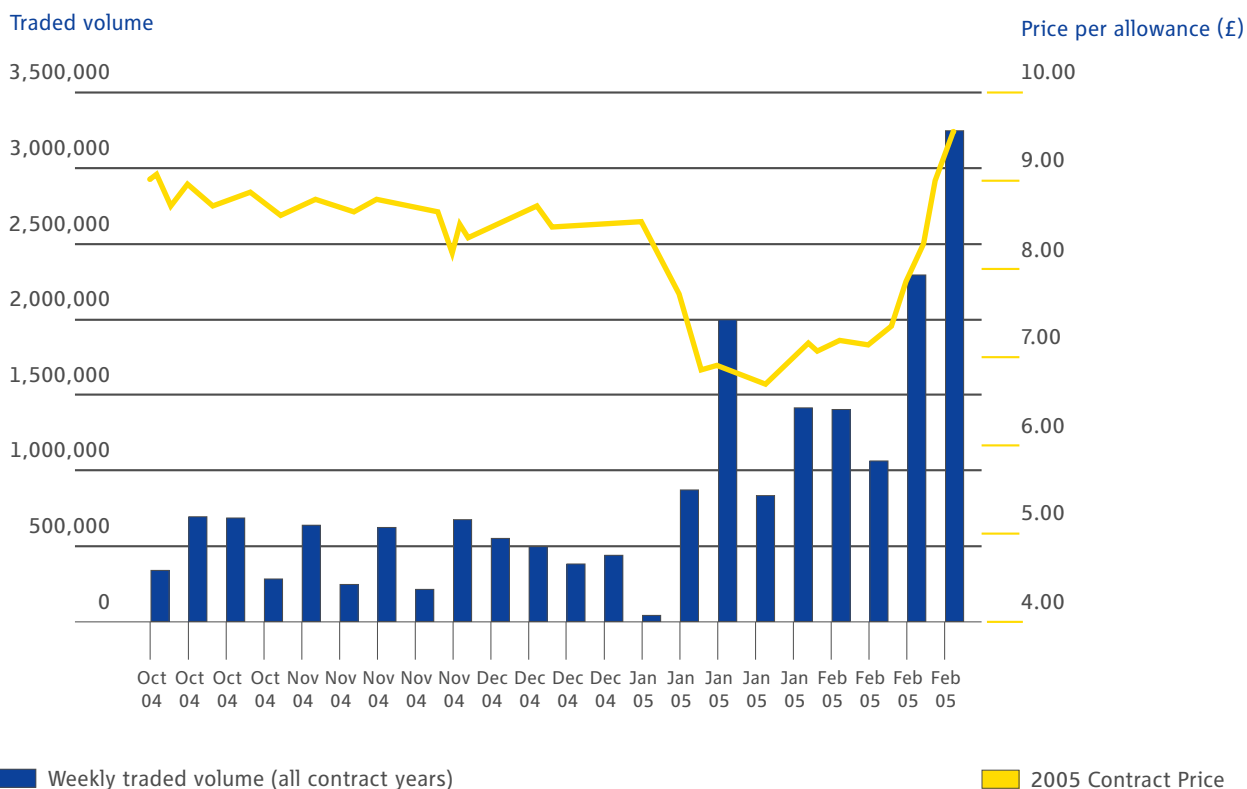
### Looking to the future

Two key issues that will affect the longevity of the ETS (within the EU and as a global approach) are linkages with other trading systems world-wide and the impact that it will have in creating demand for certified emissions reductions (CERs) and engaging developing countries. Over the next 2–3 years we can expect that systems will be set up in Norway and hopefully Canada. Linkages to these systems is unlikely to change the parameters of the EU ETS but it will give it stability, credibility and global acceptance.

The EU ETS will certainly experience changes for the second allocation period but those changes will address issues included in the Annexes to the original agreement that do not require co-decision to implement but can be done through the committee process. The priority is to ensure the success of the trading system and prove that it can deliver a reduction in CO<sub>2</sub> emissions performance and keep the EU competitive.

*Please note that the views expressed in the above paper are those of the author and do not necessarily represent the views of IETA or its members.*

Figure 4 – EU allowance prices



Source: Natsource Europe Ltd, February 2005