Emissions trading: how is it working?

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Overview

- Purpose & scope of EU ETS
- Impact so far
- Setting caps
- Allocating allowances
- Providing predictability
- Conclusions

The purpose of the EU ETS

- Cap & trade: putting a price on carbon to stimulate low carbon investment
- Most important tool for meeting EU Kyoto target of reducing greenhouse gas emissions by 8% below 1990 levels by 2008-2012
- Key to meeting EU targets post-2012, including a 20-30% cut by 2020 and 60-80% cut by 2050
- Keystone of international emissions trading, delivering investment for clean development

The scope of the EU ETS

- Covers carbon dioxide only
- Covers just under half the EU's emissions (power and energy-intensive sectors)
- Phase I runs from 2005-2007; Phase II runs from 2008-2012 (five year budget periods)
- NAP setting in hands of member states
- Maximum 5% of allowances can be auctioned in Phase I; 10% in Phase II (rest given away free).

Is it reducing emissions?

- 2005 & 2006: no emissions reductions
- Overall EU emissions rose by 1-1.5% 2005-2006.
- Industry allowed to produce 3% more emissions than needed in 2005 and 1% more in 2006

Setting caps (1)

- Over-allocation in Phase I: in 2005 & 2006 respectively, 66 & 30 million more tonnes of emissions allowances were given than emitted (causing carbon price to crash by 65% in May 2006; frequently around 1 Euro/tonne)
- Over-allocation in Phase II: the first 17 NAPs set caps 15% higher than emissions for 2005
- Member states anxious to avoid making more effort than neighbours and endangering competitiveness
- Some targets based on inflated business as usual projections & industrial lobbying.

Setting caps (2)

- EU Commission has revised Phase II NAPs
- Every NAP rejected except UK & Slovenia's
- Cut 64 million tonnes of CO2 off them
- Poland and four others has had to cut their permit total by 26%, Latvia by over half, Germany faced the largest absolute cut
- Total 6% cut on 2005 emissions
- Forward price for carbon in 2008 close to 17 Euros/tonne
- Should centralise NAP setting from Phase III, in line with EU 2020 upper target

Allocating allowances

- Auctioning accounts for just 0.2% of the entire EU emissions budget in Phase I
- Only four member states (Denmark, Hungary, Ireland and Lithuania) auctioned part of their allowances in Phase I and only a handful will auction allowances in Phase II
- Grandfathering and new entrants rules distort incentives for emissions reductions
- Should increase auctioning; set minimum limits; use product-specific benchmarks; improve entrance and closure rules.

Providing predictability

- Problems with five year budgets
- Only incentivise short-term adjustments
- Do not align with long-term investment cycles
- 86% of companies surveyed call for budget periods to increase to 10 years or more
- Deciding emissions allocations 2-3 years in advance of trading periods?

Conclusions

- Need bold legislative proposals for Phase III later this year from the EU Commission
- Need member states to support them
- Address competitiveness concerns
- Build public support for stricter caps
- Secure a post-2012 global agreement