



The EU Emissions Trading Directive: A vital EU policy initiative on climate change.

Background

On December 9th, European Environment Ministers are due to meet in Brussels to agree a very important piece of the European Community's climate change policy – the proposed greenhouse gas emissions trading directive - also called cap-and-trade. If adopted, the directive will help to set targets and timetables for emission reductions in energy-intensive industry and the power sector, covering around 46% of the EU's CO₂ emissions and set Europe firmly on the road to meeting its commitments under the Kyoto Protocol. Failure to reach agreement, however, would delay necessary investments, creating uncertainty and significantly raising the cost of this compliance. Europe's leadership on environmental issues would be thrown into question. WWF believes that if targets are set to reflect the sector's CO₂ emissions reductions potentials, such a cap and trade directive is a sound compromise between environmental credibility and economic effectiveness.

The use of a system of tradable permits based on individual corporate caps limiting emissions was first tried in the United States in response to the costs associated with meeting the goals of the US Clean Air Act in the 1970s and 1980s, and consequent non-compliance due to what was perceived as an excessive economic burden. Over the last twenty years emissions trading has become a core component of US efforts to reduce the air pollution and acid rain caused mainly by NO_x and SO₂ generated by industry and other large stationary sources of emissions and is largely seen as having been successful, in terms of both cutting air pollution beyond proposed targets and reducing the cost of meeting these targets.

The principle that underlies emissions trading is that, with a given target, the market provides the most efficient way of allocating the responsibility for reducing pollution. This occurs because, unlike a system based on fixed emissions reductions across all firms, trading allows those firms with lower abatement costs to make deeper cuts and sell their "excess reductions" to firms for whom the cost of reducing emissions is prohibitively higher. While the overall reduction remains the same, the cost of achieving it can be significantly lowered. This principle is generally supported by WWF – once the targets are set properly.

The experience in the US, however, has shown that there are a number of basic conditions which need to be in place if emissions trading is to be successful:

- The existence of clearly defined targets, based on absolute emissions allowances that are established over the medium-term and well known by firms, thus enabling them to plan their investment strategies.
- Mandatory participation by the sectors covered, to ensure targets are met and that there is a balance between buyers and sellers.
- The existence of rigorous and trusted monitoring and enforcement mechanisms.
- The existence of strict compliance regime with automatic penalties for non-compliance.
- The enforceability of contracts between buying and selling firms.
- Wide accessibility of information regarding the system, its functioning and the trades that take place.
- General public support for the system.

In the context of climate change, the concept of emissions trading as an international policy instrument was introduced into the negotiations by the U.S and a number of its allies as a condition to agreeing to binding GHG emissions cuts and subsequently incorporated in the Kyoto Protocol agreed in December 1997. While Article 17 only allows emissions trading between nations, it has created the framework for a number of local, national and regional trading schemes involving the private sector. Several of these are already operational - in Denmark, the UK and several US states – while many others are being proposed or under discussion. Of these the, the proposed EU scheme will be by far the largest and most influential in terms of setting regulatory precedents and internal price for GHG allowances.

The EU emissions trading directive

Under the Kyoto Protocol, the European Union agreed to reduce its GHG emissions by 8% below their 1990 levels. Subsequently, this target was reallocated internally, such that countries with greater ability to cut their emissions (Germany, Denmark, UK) have taken on tougher targets, while others have been allowed to let their emissions grow. This is known as the EU bubble: in order to comply with the Kyoto obligation, all the Member States and the European Union as a whole must meet these targets. This has set the stage for the development of Europe-wide policies (in parallel with a number of national initiatives), with the introduction of emissions trading being the first of these.

After a long process of consultation and research the European Commission proposed draft directive in October 2001. Covering those sectors included in the already agreed Industrial Prevention and Pollution Control Directive (IPPC) its main components are:

- A mandatory absolute emissions cap on participating firms, covering CO₂ and, when accurately measurable the five other greenhouse gases.
- Targets to be set and allowances allocated by national governments on the basis of their Kyoto commitments and European competition rules.
- A pilot phase for gaining experience and to promote early action between 2005 and 2007, and a full operational phase during the 2008-12 Kyoto commitment period.
- A fine for non-compliance of €100/tonne CO₂e (€50 during the pilot phase).
- Monitoring, reporting and transparency provisions

The proposed directive was discussed and approved with a number of compromise amendments by the European Parliament in September this year. Member State governments have, meanwhile, been considering the proposal since late last year and, in their meeting in October 2002, Environment Ministers agreed to take a final decision on December 9th.

Nevertheless there are still a number of outstanding issues which, if not resolved satisfactorily, will undermine the Directive. The most important of these are:

The right of sectors or firms to opt-out, either directly or through the establishment of pools that transfer individual firms' responsibilities to their governments or industry associations. This should be rejected, as the result would be to allow potential buyers to be exempted. The market would then be flooded with permit sellers only destroying the market and with it the potential for cost reductions and the incentive for early action. Furthermore, if country A were allowed to exempt a certain industry from cap and trade, incentives would be created for country B to exempt the same industrial sector for competitiveness reasons, regardless of its potential role as a buyer or seller of carbon permits. Such a chain reaction is counterproductive and the guarantee of industry's contribution to the Kyoto target would be broken.

- *The use of relative rather than absolute caps on emissions.* The use of absolute fixed emissions targets is the only way to ensure that the emissions trading scheme delivers on its environmental objective. Linking allowed emissions to the economic growth or output, would

create uncertainty, weaken the market's operations and potentially lead to higher costs for other sectors.

- *The unrestricted inclusion of allowances and credits from outside the EU.* Allowing the use of outside emission credits such as from the Kyoto Flexible Mechanisms to meet the targets under the EU cap and trade system may help companies in the short term to comply cheaply but do not bring significant economic benefits in the medium term. In particular, use of allowances from countries that have not invested to reduce their emissions or project credits arising from environmentally suspect forestry, fossil-fuel and large hydro projects is likely allow global emissions to increase while removing the incentive for technological innovation and long-term investment. WWF has been working to develop – with EC support – as Gold Standard for GHG emission reduction projects that focus on promoting renewable energy and top-end demand-side energy efficiency. If any credits from these activities are to be allowed to enter the EU cap and trade system, then they should be restricted to those that meet this Gold Standard.

Industry and governments must realise that a fully comprehensive cap and trade system – in conjunction with equally rigorous policies covering the commercial, residential, agricultural and transport sectors - represents by far the easiest and cheapest way for Europe to meet its Kyoto targets and make the investments necessary to turn the need for emissions reductions into an opportunity for the development of new low-carbon technologies rather than an economic burden.

Conclusions

The EU Environment Council meeting on December 9th offers European ministers an opportunity to put the leadership it has shown in international negotiations into concrete practice. Adoption of the proposed emissions trading Directive without the incorporation of loopholes will demonstrate Europe's seriousness and establish a clear framework in which firms can plan their investments over the coming decade.

Failure to establish a credible emissions trading system in the EU, for whatever reason, will automatically require government action to control greenhouse gas emissions in the sectors concerned in a more direct way, to ensure that the legally binding Kyoto targets are met. For industry, these domestic actions – high carbon or energy taxes or command and control measures - are likely to be more costly than achieving emission reductions through an EU-wide cap and trade scheme, and may take a long time to be approved, generating further uncertainty.

Europe's credibility, its ability to meet its Kyoto targets, the potential to achieve this at minimum cost, and the will to pave the way for even deeper reductions in the future beyond the first set of Kyoto targets thus rests on the early adoption of a rigorous cap and trade directive. It is an opportunity that should not be missed.

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