



FREEZING CLIMATE CHANGE

WWF POSITION STATEMENT – CLIMATE & ENERGY PACKAGE

Questions & Answers on the EU Emissions Trading Scheme

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THE EU EMISSIONS TRADING SCHEME (EU ETS) – GENERAL QUESTIONS

- What is – in short – the European Emission Trading Scheme?

In 2005, the European Union Emissions Trading Scheme (EU ETS) came into force. The scheme is a crucial cornerstone of the efforts being made by the EU member states to fulfil their legal obligations under the Kyoto Protocol. Under Kyoto, the EU has committed to reduce greenhouse gas emissions by 8 per cent by 2008 to 2012. The European Commission describes the scheme as such:

“The EU ETS is a ‘cap and trade’ system, that is to say it caps the overall level of emissions allowed but, within that limit, allows participants in the system to buy and sell allowances as they require. These allowances are the common trading ‘currency’ at the heart of the system. One allowance gives the holder the right to emit one tonne of CO₂. The cap on the total number of allowances is what creates scarcity in the market. [...] Companies that keep their emissions below the level of their allowances can sell their excess allowances. Those facing difficulty in keeping their emissions in line with their allowances have a choice between taking measures to reduce their own emissions - such as investing in more efficient technology or using less carbon-intensive energy sources - or buying the extra allowances they need on the market, or a combination of the two. Such choices are likely to be determined by relative costs. In this way, emissions are reduced wherever it is most cost-effective to do so.”¹

The scheme currently covers over 12,000 installations in the energy and industrial sectors which together cover almost half of the EU's total CO₂ emissions. From 2011 or 2012 it is proposed that the aviation sector be included in the scheme. Sectors covered today by the scheme include:

- Electricity generation
- Iron & steel

- Mineral processing industries such as cement and glass manufacture
- Pulp and paper processing industries

As of 30 May the price of emission allowances, known as EUA's (EU allowances) trading on the market was €26.45².

- What are the main differences between the phases I, II and III of the EU ETS? What are the main results so far?

Phase 1 (2005 - 2007)

- National allocation plans with free allocation for EU ETS sectors

Results:

- Vast over-allocations: Emissions³ were significantly below the level of the overall cap. Even though some studies⁴ claim the surplus of allowances can be attributed to abatement actions, we see industrial emissions keep on increasing. Whether there is some abatement or not does not really matter. There was clearly over-allocation in the first period meaning that there are more allowances than required to reach a significant emission reduction target.
- This caused the carbon price to plummet until a price less than 1 Euro.
- As a consequence, the first phase of the scheme likely had very little impact on reduction emissions within the EU.
- Free allocation of allowances also resulted in the accumulation of windfall profits by the power sector in the first phase (at least until the crash of the carbon price) where the value of allowances was passed through to the price of power⁵.

Phase 2 (2008 - 2012)

- The second phase of EU ETS falls within the first commitment period of the Kyoto Protocol. This means that from 2008 onwards European Member States have to reduce their emissions following the regulations in the Kyoto-Protokol.

¹ <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/35&format=HTML&aged=0&language=EN&guiLanguage=en>

² <http://www.pointcarbon.com>, 30 May 2008.

³ This was shown with the release of the verified emissions data (from installations covered by the EU ETS) in May 2006.

⁴ Ellermann / Buchner (2006): Over-Allocation or Abatement? A Preliminary Analysis of the EU ETS Based on the 2005 Emissions Data.

⁵ For example it is estimated that UK power companies alone gained £1.2-1.3 billion in 2005: <http://www.defra.gov.uk/corporate/consult/climatechange-bill/ria.pdf>. For more information on windfall profits see question 3.1.

- Therefore, the European Commission has reduced the proposed member states allocation plans by 10.5% in total⁶.
- Partly auctioning of EU allowances for the power sector (circa. 3-4 %)

Results:

- Access to vast volumes of project credits from Clean Development Mechanism or Joint Implementation projects. This could potentially mean that all of the emission reductions could take place outside the EU sectors (and potentially outside the EU).
- This could result in emissions in the EU actually increasing over and above emissions in phase I.
- Further windfall profits in the power sector (and likely other sectors) throughout phase II due to the free allocation of allowances⁷.

In January 2008 the European Commission presented a draft revised EU ETS Directive which seeks to make changes to the scheme post 2012⁸. This proposal is now making its way through the EU decision process. The proposal includes:

- In line with the 2007 Spring Council conclusions, the European Commission has proposed two scenarios for phase III of the EU-ETS. Call for a reduction in EU emissions of at least 20% by 2020 compared with 1990 levels, and by 30% provided that other industrialised countries commit to comparable efforts in the framework of a global agreement to combat climate change post-2012.

Sub-targets to the 20 % scenario:

- Emission reduction target from 2013: only 21 % EU emission reduction target
- 100% auctioning for the power sector from 2013
- free allocations of allowances to other sectors phased out from 2013 onwards, resulting in no free allocation in 2020
- credits from projects in developing countries (CDM) are allowed to enter the EU ETS by 5,6 % of 2013-2020 Cap (or 25 % of reduction effort)

- Only 20 % of auctioning revenues to be allocated for climate protection measures.

- According to WWF, does the EU ETS contribute to tackle climate change on a global scale?

Whilst the EU ETS to date has likely not contributed significantly to cuts in emissions within the EU. But it has clearly been important in:

- establishing a price and market for carbon and
- beginning to drive low carbon investment in the developing world via its link to the Clean Development Mechanism.

Ultimately we need a global carbon market which caps emissions at a level in line with the science. The development of the EU ETS is a step along this path and is influencing the development of national and regional trading schemes around the world (e.g. the Regional Greenhouse Gas Initiative in the U.S).

Key to the success of the EU ETS post 2012 will be the extent to which it positively influences both operational but crucially investment decisions of European industries, whilst minimising competitive distortions and driving low carbon investment in developing countries. The review of the scheme by the EU comes at an opportune time in the lead up to the international climate negotiations for a post 2012 global deal which should conclude at the conference in Copenhagen at the end of 2009.

The revised EU ETS is being negotiated as part of the EU's climate and energy package which also includes proposals on effort sharing between Member States of the 2020 greenhouse gas emission reduction target, propals on renewables and Carbon Capture and Storage.

In order for the EU to maintain its leadership position in the international negotiations it is crucial that this package of measures is robust and is agreed on before the decisive Copenhagen conference.

⁶ <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1614&format=HTML&aged=1&language=EN&guiLanguage=en>

⁷ A recent study by Point Carbon for WWF which looked at the power sector in the UK, Germany, Spain, Italy and Poland, concluded that windfall profits could amount to €71 billion by the end of 2012. For more information: http://www.wwf.org.uk/filelibrary/pdf/ets_windfall_report_0408.pdf and WWF summary here http://www.wwf.org.uk/filelibrary/pdf/eu_ets_summary_0408.pdf

⁸ http://ec.europa.eu/environment/climat/emission/pdf/com_2008_16_en.pdf

- Is only Europe trying to reduce emissions or are other countries engaging in this direction too?

Countries that ratify the Kyoto Protocol commit to reducing their emissions of carbon dioxide and five other greenhouse gases (GHG). Some of them are engaging in emissions trading systems. The Kyoto Protocol now covers more than 170 countries globally. As of December 2007, the US and Kazakhstan are the only signatory nations not to have ratified the act.

Examples of commitments in the Kyoto-Protocol

Party	Quantified emission reduction commitment (in percent compared to 1990)
Australia	+8
Austria	-8
Canada	-6
Czech Republic	-8
European Community	-8
Japan	-6
Liechtenstein	-8
Monaco	-8
New Zealand	0
Russian Federation	0
United Kingdom of Great Britain and Northern Ireland	-8
United States of America	-7

Countries such as China and India also ratified the Kyoto-protocol but they are not yet obliged to reduce their emissions. Nevertheless they are aware of the problems caused by climate change and take part in CDM projects.

- What is the current cap on emissions and how are emission allowances distributed?

The overall cap for phase II of the scheme (2008 to 2012) has been set at 2,083 Million tonnes of CO₂ per year⁹. In the main allowances have been distributed for free with

only a small proportion (circa. 3-4%) allocated by auction.

- What is the emission reduction that WWF envisages for sectors covered by the EU ETS by 2020 and 2050?

In order for the EU ETS to contribute its fair share of the necessary overall 30% EU-wide greenhouse gas reduction target by 2020 (below 1990 levels), WWF considers that the EU ETS should achieve an emission reduction of 36% below 2005 levels by 2020. WWF agrees with the current proposal from the European Commission that the EU ETS sectors should continue to deliver two-thirds of the share of the overall emission reduction effort of the economy.

AUCTIONING OF POLLUTION PERMITS IN EUROPE

- Why is WWF advocating for 100% auctioning of pollution permits instead of other methods of allocation?

Commission proposal:

- 100% auctioning in the power sector starting in 2013
- Other sectors: free allocations will be phased out from 2013 on, resulting in no free allocation in 2020

WWF position:

Benefits of auctioning emission allowances:

- It ensures the full cost of carbon is factored into investment decisions.
- It supports the 'polluter pays principle'.
- It avoids the accumulation of windfall profits to the most polluting sectors that can come about as a result of free allocation. See also Footnote 6 and Question 1.2: Report WWF / Point Carbon estimates up 71 billion Euros of windfall profits in Phase II (2008-2012) of the EU ETS for the power sectors in Germany, UK, Poland, Spain and Italy.
- It rewards the most efficient low carbon production.

⁹<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/35&format=HTML&aged=0&language=EN&guiLanguage=en>

Problem of "Carbon Leakage" for energy intensive industry

WWF accepts that in the absence of an international agreement on climate change, some of the large energy intensive industries might have disadvantages because of the EU ETS. But in order to evaluate which industries are affected by this and how much they might suffer, the European Commission should investigate this in a comprehensive, factual and transparent evaluation based on independently verified data. Until this is done, WWF calls for 100% auctioning for all sectors from 2013 onwards. Specifically we believe the aviation sector should pay for all of its allowances from 2013.

- Isn't the EU ETS harming the power sector which is key for the economy?

No. The power sector has benefited from the scheme to date by accumulating massive windfall profits due to the free allocation of allowances. Full auctioning of allowances from 2013 will help to incentivise investment towards low carbon forms of power generation.

- Will auctioning lead to an increase in energy prices?

In the first (2005-07) and second (2008-12) period of the ETS, most European energy companies have already passed through the cost of carbon into the price of electricity to their customers. Even though they have received their allocations mostly for free. So auctioning will not result in further increases in energy prices.¹⁰

It is important to remember that emission trading is a mechanism to help achieve emission reduction targets at least cost. In the context of its impact on electricity prices it is just one of several factors which affect the price. These also include the global price of fuel (oil and gas prices have a significant impact on price), transportation and distribution costs, services and taxes. Indeed, depending on the degree to which the energy efficiency target of 20% savings is achieved – the total bill for households may not increase at all.¹¹

- Is the EU ETS and auctioning of pollution permits threatening competitiveness of key economic sectors in Europe?

Competitiveness losses have always been put forward by industry when discussing environmental policies. However, the negative impact of environmental policies on competitiveness turns to be an old myth. Industry as a whole is not sensitive to competitiveness losses as a result of the EU ETS. If some industries are sensitive, this regard only sub-sectors. But these sub-sectors are generally not the ones who cry wolf and undermine the credibility of the industry as a whole.

According to a report released in January 2008 by Climate Strategies¹², of the 159 sectors in the EU ETS the study investigated, it concluded that only 23 may experience a 'non negligible' cost impact as a result of the scheme¹³. In addition, the exposure of these sectors to trade with non EU countries turns out to be low in general. Similar results were drawn for German industries by a report by Öko-Institut¹⁴. Therefore, the highly energy-intensive industries (which are also CO₂ intensive) are generally not very exposed to international competition. Indeed, they turn out to be heavy industry sectors with many barriers to trade such as transportation costs. For the sectors whose trade exposure is high, the main determinants of trade are not energy prices or environmental policies; they are quality of workforce or access to technology.

WWF considers that the completion of a robust post 2012 international agreement on climate change should remove competitive distortions associated with the EU ETS. As such any discussion about support measures should take place in the event of an international agreement not being concluded. In light of this, we welcome European Commission's decision to identify, by 2011, the sectors sensitive to relocation and for which measures to address this should be considered. The identification process should be based on robust scientific know-how, instead of unverified facts and data provided by the industry.

¹⁰ This so called 'pass through' occurs because in deciding to generate, a power producer will use up both its fuel and the carbon allowances required to cover the emissions from that generation. The carbon price is therefore an opportunity cost and generators will not generate electricity unless the price of power exceeds the generating components (e.g. fuel). This now includes also the value of pollution allowances.

¹¹ "Questions and Answers on the Commission's proposal to revise the EU Emissions Trading System" Memo from the European Commission, 28 January 2008 <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/35&format=HTML&aged=0&language=EN&guiLanguage=en>

¹² A research network led by the University of Cambridge for the UK.

¹³ Differentiation and dynamics of EU ETS industrial competitiveness impacts, Climate Strategies, 2008. Available at www.climate-strategies.org

¹⁴ Impacts of the EU Emissions Trading Scheme on the industrial competitiveness in Germany. Report by Öko-Institut, DIW Berlin and the Fraunhofer Institut. March 2008

• Is the EU ETS and auctioning of pollution permits threatening jobs in Europe?

The 23 sectors, identified in the Climate Strategies report² as having a 'non negligible' cost impact as a result of the EU ETS, represent around 1% of the UK's GDP and only 0.5% of its employment. Indeed carbon intensive industry sectors are generally much less job intensive than the average for the economy.

The EU ETS and climate policies in general will not inhibit growth and employment. Indeed a robust EU ETS and other climate and energy policies will pave the way for an energy efficient low carbon economy creating jobs in new sectors (such as renewable energies for instance¹⁵) and providing cost-savings across all sectors. Security of energy supply will be increased via reduced dependence on foreign energy sources. In addition, an increase in the contribution of renewable energy sources will boost the EU's technological lead, creating large export potentials and EU jobs. Reduced dependence on fossil fuels will also provide health benefits and reduced health costs through improved technology and cleaner energy sources.

• How does WWF think revenues from auctioning should be spent?

Commission proposal:

- Only 20 % of auctioning revenues for climate protection measures

WWF position:

Climate change is caused mainly by the present and historical emissions of industrialised countries such as the EU Member States. But the most dangerous effects occur in developing countries. The EU has therefore a responsibility to compensate developing countries for actual and future damages. The EU thus needs to offer substantial investment to help developing countries, for example:

- To adapt, where possible, to the impacts of climate change;

- To mitigate future climate change through the direct development and transfer of clean technology, capacity building, reducing emissions from deforestation and forest degradation;
- To create a sustainable development path which contributes to the right of the world's poorest to a safer, healthier and better life.

Under the current proposal the Commission estimates that by 2020 revenues from auctioning could amount to 50 billion Euros per year. If governments are serious about achieving the reductions in emissions we need to stay well below a 2°C global warming, then ALL revenue needs to be committed to climate mitigation and adaptation activities. Therefore WWF recommendations are that all auctioning revenues be used to fund climate protection and adaptation measures:

- At least 50% of the auctioning revenues to go to assistance for developing countries;
- The remaining 50% of revenues earmarked for climate mitigation and adaptation activities within the EU.

CREDITS FROM CLEAN DEVELOPMENT MECHANISM (CDM)

- How many external credits from the Clean Development Mechanism are allowed in the ETS in phase II of the EU ETS (2008-12)?

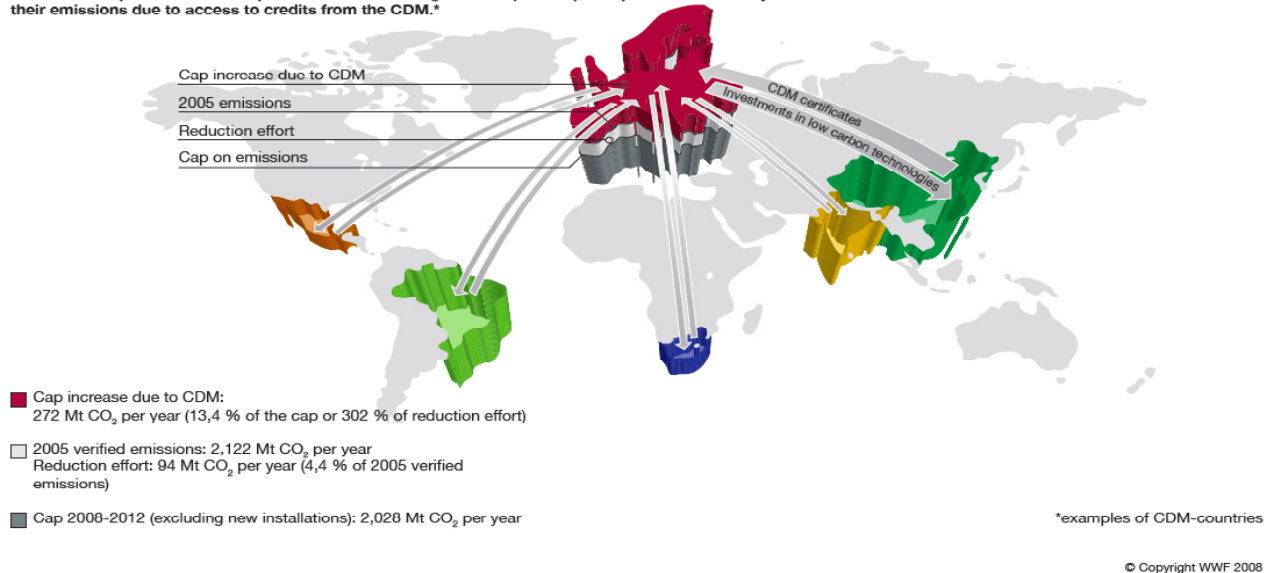
In Phase 2, 13.4 % of the cap is allowed to be imported as CDM/JI into the EU ETS. This corresponds to 272 million tons CO₂ per year. At the same time, the overall reduction effort of the European Member States is only 4.4 % of 2005 emissions or 94 million tons CO₂ per year. (See the graphics)

This high access to excessively large volumes of carbon credits in phase II of the EU ETS might mean that emissions from sectors covered by the ETS could actually increase by 178 million tonnes of CO₂ over their 2005 levels - equivalent to the annual emissions from approximately 37 coal-fired power stations. Clearly, this is not acceptable for a scheme which is meant to be driving down emission reductions within the EU.

¹⁵ For example the wind energy industry created about 150,000 jobs in all Europe by end of 2006, of that 80,000 in Germany, 22,000 in Denmark, 35,000 in Spain. There are prognoses that for the EU those numbers may be up to 370,000 by 2020 (source: 'Wind Directions', April/May 2008, page 11, quoting national employment statistics).

Access to credits from the Clean Development Mechanism today (2008 - 2012) could lead to an increase in European emissions

In the second period of the European Emissions Trading Scheme (EU ETS), companies can actually increase their emissions due to access to credits from the CDM.*



- According to WWF, what should be the maximum amount of external credits and why?

Commission proposal:

- 20% scenario: only banking from the 2nd phase (only CDM-credits which were not used up in the former period) + new CDM projects from Least Developed Countries
- After an international agreement is adopted, 30% scenario: banking + CDM/JI use up to half of the reduction taking place due to the international agreement, which mean half of the difference in the reduction between 20% and 30%.

WWF position

Too much access by companies in the EU ETS to emission reduction credits outside the EU will both delay domestic reductions and keep investments in high-carbon infrastructure - such as new unabated coal-fired power stations - financially viable. This could lock us in to soaring CO₂ emissions in the EU for decades to come - putting 2020 and longer term targets out of reach - or at a minimum making future reductions much more costly for taxpayers and companies to meet.

Providing clear financial incentives to reward low carbon investment within the EU, on the other hand, will stimulate innovation and employment opportunities for the existing and future workforce of Europe. At the same time, it is crucial that the EU contributes substantively to the low-carbon pathway of developing countries, assists them in reducing emissions from deforestation and forest degradation and in adapting to the impacts of climate change. WWF believes the best way to achieve a balance between these twin goals of promoting emission reductions within the EU and helping developing countries is for a non-European emission reduction target to be added to the 30% EU-wide greenhouse gas target. Therefore, WWF recommends that:

- Europe commits to the financial equivalent of an additional 15% emission reduction to be achieved outside the EU, in addition to the 30% EU-wide target - with the EU ETS sectors taking on their fair share of this target, and
- The additional 15% is achieved through the use of new and existing market mechanisms and financial instruments for mitigation and adaptation activities, including an improved reformed CDM.

- How can we be sure that external credits really deliver greenhouse gas emissions and contribute to sustainable development?

The Clean Development Mechanism was created by the UNFCCC to provide industrialised countries with a way to meet parts of their emission reduction targets more cheaply, by investing in emission reduction projects in the developing world. Its twin aim is to provide sustainable development benefits to the host countries of these projects. It is therefore crucial that this dual objective is reflected in CDM projects.

However, WWF is concerned the quality of CDM credits, particularly around whether the projects would have taken place anyway, without the additional revenues from the CDM (so-called “non-additional” projects). A project can be called ‘additional’, if it would not have been implemented without the credits from the CDM. CDM registered projects receive credits for every ton of CO₂ that is reduced. Those credits can be traded on the international carbon market and can be used to emit a ton of CO₂ for example in Europe.

So this means that in case a CDM project is not ‘additional’ and its credits enter the EU ETS, they actually increase the global emissions instead of reducing them.

To ensure that projects really are additional, have a positive sustainable development impact, and contribute to a low carbon economy the use of project credits within the EU ETS should be limited to those certified by the Gold Standard (see also next question).

- Why does WWF believe that Gold Standard is better than other standards?

The Gold Standard is an independent, transparent, internationally recognised high quality label for carbon offset projects. It is restricted to renewable energy and end-use efficiency projects such as wind farms, biomass plants or end-use energy saving measures. The Gold Standard requires projects to follow a conservative interpretation of the UNFCCC-additionality test, which means that those projects have to be additional in order to really reduce emissions instead of potentially increase them. Gold Standard project also have to provide evidence by a UNFCCC-accredited independent third party that they are making a real contribution to sustainable development.

FOR FURTHER INFORMATION:

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