

Key issues surrounding the future of Carbon Trading in Europe

The EU faces some very difficult decisions over the next phase of ETS. According to Andrei Marcu of the International Emissions Trading Association (IETA), the scheme has been a market success but the real test is whether the scheme will reduce CO₂ emissions in line with the EU's Kyoto target. European network is hindering development.

Was Phase One a success?

There is no doubt that the EU ETS is a success as a market instrument. This statement can be supported by some emerging facts. In the first 12 months the EU carbon market was already worth US\$ 6.3 billion which equates to 322 million tonnes of CO₂ (World Bank/IETA "State of the carbon market"). Its volume is likely to double in 2006 with 3 million tonnes on average traded per day.

A new market is developing around the EU ETS infrastructure and companies are increasingly aware of the financial opportunities provided by the scheme. Emission prices have already given clear incentives to utilities to switch from coal to gas – the cheapest large scale abatement option on a short term basis - throughout the summer 2005 leading to some 100Mt of CO₂ reductions.

The EU ETS has also been the driving force behind the extraordinary CDM market which addresses real sustainable issues in the developing world. The project-based carbon market now represents 364Mt of reduction in 2005 (World Bank/IETA).

CDM and JI will also keep EU industry globally competitive by providing emissions

reduction opportunities in the developing world at the lowest possible costs.

What is likely to happen to carbon prices in Phase Two?

Phase One has seen highly volatile trading periods. Bids and offers have been consistently available across many trading platforms and market participants have mostly been able to get in and out of trading positions. Price volatility has also occurred because of the un-coordinated release of April 2006 verification reports of EU Member States, which showed the total allocated allowances to be greater than the verified CO₂ emissions.

In this respect, NAPs are central to the efficiency of any price mechanism in a trading scheme. NAPs must ensure that ►



there is scarcity in the market and a level playing field for industry. Together with the number of CERs and ERUs allowed into the scheme, they are fundamental to the future price of EUAs (European Allowances) over 2008-12.

If the Commission fails to insist on sufficiently strong NAPs then this could lead to a looser than expected cap in the ETS over Phase Two. Current published NAPs however show that targets will gradually be stricter to meet Kyoto targets. If this tendency is confirmed, Phase Two will be significantly shorter and emissions reductions will be made. This in turn will provide the market with a strong signal to reduce emissions.

Will prices be allowed to rise to a point where we see significant reductions in emissions?

The EU is committed to emissions trading as a long term tool for reducing CO₂ in the EU. In this scenario, successful markets depend on a secure long-term legal framework to give confidence that legal obligations will be met with strict, verified and transparent compliance. The best way to ensure that prices do not go through the roof is to allow substantial numbers of project-based credits, which will help keep industry competitive.

What progress are we likely to see on the longer term future of ETS?

The EU ETS is still work-in-progress and we can clearly see a staged approach towards making the scheme more robust, wide and deep:

1. During 2006-2007: finalising the complete infrastructure of the system.
2. For 2008-2012: need for consistency and integrity of NAPs.

3. For post 2012: changes should aim to further improve and widen the GHG market through amendments to the Emissions Trading Directive.

As to the post 2012 regime much will also depend on how the EU ETS and other schemes can link. The objective will be to make these different systems compatible without compromising the effectiveness of the various systems.

European environmental policy is characterized by a delicate balance between Member States and the European Commission competencies. Member States have legislative power in major issues of climate change including major aspects of energy policy. They will also want reassurance that they can maintain a firm grip on national allocation targets between the trading and the non-trading sector. The European Commission on the other hand will push for the Single Market in emission trading such as EU rules for new entrants/transfers/closure of installations and for a central New Entrant Reserve.

A serious discussion will be needed on the inclusion of other sectors beyond the 11,500 energy-intensive installations producing almost half of the EU's total CO₂ emissions. Among the sectors currently



excluded, aviation is already a candidate to enter the scheme as early as 2010.

What progress are we likely to see with other international CO₂ trading schemes?

The EU ETS has no “sunset clause.” Emphasis will be on its improved implementation, its extension to other sectors and linking to other schemes as they develop.

Linking is already happening with developing countries through the CDM and JI mechanisms originating from the Kyoto Protocol. But new schemes are emerging and could become candidates to link up with the EU ETS:

1. In **California AB32** authorises, but does not require, the California Air Resources Board – which regulates CO₂ emissions in the state – to implement market-based compliance mechanisms. Regulation is only becoming effective in 2010. It is widely expected that some form of emissions trading will be introduced.

2. The **Regional Greenhouse Gas Initiative (RGGI)**, is a US cooperative effort by North eastern and Mid-Atlantic states to reduce GHG emissions. To address this important environmental issue, the RGGI participating states will be developing a regional strategy for controlling emissions from their electrical power sector. Central to this initiative is the implementation of a multi-state *cap-and-trade programme* with a market-based *emissions trading system*. The proposed programme will require electric power generators in participating states to reduce CO₂ emissions.

3. The State Governments of **Australia** are investigating the feasibility of a national emissions trading system as part of a

comprehensive strategy to help Australia address the challenges of climate change. To date four discussion papers and two consultancies on emissions trading have been released and these are stimulating much debate on the many policy issues associated with the design of a national emissions trading system.

4. In 2003, the Australian **New South Wales (NSW)** Government introduced an emissions trading scheme building on an existing emissions benchmarking program in connection with electricity retailer licensing conditions. The benchmark system requires electricity retailers to reduce annual emissions from 8.65 to 7.27 tonnes CO₂ equivalent per capita. All six GHGs expressed as units of one tonne of are CO₂ covered. They can achieve the targets by offsetting their liability with credits created from renewable energy and low emission generation, tree planting and energy efficiency. Each participant has a benchmark obligation assigned to their



operation, and will have to submit emissions accounts equaling their target each year.

5. In **Japan** a voluntary emission trading scheme has been established over the last year. It is similar to the "old" UK scheme as it provides for subsidies with industries participating in the scheme. The government has not yet envisaged any linking with the EU scheme but the option may come up one day.

Judging the effectiveness of the ETS

Eyes are now on the international community which is about to start two years of crucial discussions on further global action to combat climate change after 2012, when the Kyoto Protocol targets expire. Emissions trading, CDM and JI are likely to play a central role in whatever

shape this new agreement will take.

Finland will be leading the EU delegation at the annual United Nations ministerial conference on climate change (UNFCCC) in November in Nairobi and has already expressed a strong interest in advancing the discussions on post 2012.

To conclude, in times when scientists are issuing stark warnings on the effects of global warming, the EU ETS will be measured against its environmental delivery. The next EU ETS trading period is to start in 2008 coinciding with the first Kyoto commitment period. Combined emissions in the EU-15 are still above the 1990 baseline compared with a commitment to achieve a reduction of 8% in CO₂ emissions by 2008-2012. To achieve the Kyoto targets ETS needs to work. Only then can the scheme lead the rest of the world by example. ■

