

## **Position Paper May 2006**

### **European Emissions Trading: Beyond Links and towards Global Expansion**

#### **A. Introduction**

Since 1<sup>st</sup> January 2005 the European Union has an Emissions Trading Scheme (ETS) in place. Its goal is to attribute to greenhouse gas (GHG) emissions<sup>1</sup> a market price, thus giving companies an incentive to invest in GHG abatement. So far, the ETS has been restricted to the 25 EU member states. From 2008 the Kyoto Protocol requires also other signatory countries to restrict their GHG emissions. Consequently, apart from the EU ETS, other trading schemes are developing or will be developed around the world. The necessity for linking the EU ETS to other schemes for GHG emissions trading is founded on the fact that climate change is a global problem, which cannot be solved by single countries or single regions. On the contrary it must be a task for the worldwide community. Furthermore, the Kyoto Protocol flexible mechanisms, Joint Implementation (JI) and the Clean Development Mechanism (CDM), lead to a close indirect relationship of trading systems even when they are not directly coupled.

The main benefit of emissions trading as an instrument to reduce emissions is that it establishes a market-based mechanism for identifying the most cost-effective means to reduce GHG emissions. A sufficiently large market area, in terms of geographical and sectoral coverage, is a prerequisite for liquidity and thereby cost-efficiency. Thus extension of the market to the global level, by linking the different local initiatives into a common market, would maximise the benefits of emissions trading, while ensuring maximum environmental gains.

Though the situation for post-2012 climate change policy is rather unclear at the moment, we believe that our conclusions in this paper are also particularly useful for the time periods after 2012. We stress that investments in clean technology by energy producers and electricity generators, as well as energy-consuming companies, require long-term certainty on emission targets and climate change policy. Power markets are affected in this respect by doubts about the relative costs or benefits of burning greater or lesser amounts of carbon-rich fuels in more or less efficient generating plants. Indeed the forward markets for all energy-related commodities and contracts traded in Europe incorporate the current political uncertainty. A clear political decision on the further development of the EU ETS is therefore needed as soon as possible.

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<sup>1</sup> Currently only CO2 emissions are covered by the EU ETS, but the ETS Directive provides for inclusion of other Greenhouse Gases

## B. Experiences with the EU ETS and recommendations

The experiences with the EU ETS so far should be used to make the emissions trading markets, including the markets created by the Kyoto Protocol, more efficient. One of the main lessons learned is that because the EU-ETS only covers the EU countries and a subset of activities within them, competitive disadvantages for energy intensive industry within the EU may occur. Power prices in European markets have risen partly as a natural consequence of the internalising of new CO<sub>2</sub> emission costs, including the incorporation of the opportunity cost of GHG abatements in generators' offers to the wholesale electricity markets.

One possible solution to the competitiveness issue is to extend the EU ETS-type model to as many other countries and sectors as possible, as soon as possible. (As long as extensions are not undertaken, those countries and sectors, lacking economic incentives to minimize their environmental impact, may well continue increasing their relative GHG emissions to the atmosphere.) EFET favours such an extension, since we firmly believe in harmonised, market-oriented solutions across *all territories* where a policy goal is to be applied.

There have been several extensive studies of the Kyoto reduction mechanisms. One of their common key conclusions is that linking of credits to emissions trading markets could significantly reduce costs for participants and increase the environmental effectiveness of emissions trading markets. This would lead to lower worldwide abatement costs, which in turn could help protect European industry against the effects of rising emission allowance prices. In addition, it could be a crucial argument for involving other countries currently not participating in the scheme.

To ensure the maximum environmental effect, while not putting the competitiveness of European industry at stake, it would be preferable to establish a single over-arching scheme from the outset rather than to rely on the organic growth of an international scheme by well-motivated companies, economies or regions (e.g. Canada, Japan and the EU). Moreover, focusing the development of an international scheme on a sub-set of nations runs the risk of:

- Undermining the effectiveness of the scheme in limiting global emissions, as emissions continue to rise in non-participating countries.
- Jeopardising the current positive perception of emissions reduction in participant countries, leading to pressure to leave the scheme and/or never to enter it in the first place.

- Diversion of energy intensive production facility investment to non-participating countries, thereby potentially increasing transport-related emissions related to movement of raw materials and/or finished products and potentially diverting resources to less efficient technologies and processes, which are only “economic” when the cost of carbon dioxide emissions can be ignored
- Inefficient allocation of abatement measures, as low-cost reduction options in non-participating countries are overlooked.

### C. Links to Other Allowance Trading Markets

Emission trading schemes are emerging in Norway, Switzerland, Canada, Japan and even some of the United States. Ideally, these schemes should be linked to each other from the start, under the condition that certain criteria be fulfilled:

- Clear and transparent trading rules for all market actors are in place;
- Sectoral and gases coverage is broadly similar between schemes;
- Comparable objectives within the applicable cap-and-trade arrangements apply;
- Mandatory rather than voluntary targets are used;
- No price caps, on the value of allowances when bought or sold, are introduced.

Meeting these criteria would enable the mutual recognition of the different allowances. Mutual recognition would be a prerequisite for introducing a “uniform worldwide currency” for GHG emissions allowances. This would help to develop a standardized “commodity”, which, when synthesised into a contract, such as the EFET standard master agreement, can easily be traded. Standardized definitions of what is an allowance, including what rights and obligations attach to it, and a standardized contract design for buying and selling allowances, would help ensure the economic efficiency of a potentially global common trading scheme.

To this end several operational issues have to be addressed:

- Access to operational national registries for all participants;
- The ITL (International Transaction Log) has to be fully operational;
- Legal issues, including the requirements from the financial inspection authorities;
- Common trading procedures (master agreements);
- Tax-related issues;
- Common procedures for monitoring, reporting and verification of emissions;
- Common accounting procedures.

The extension of the markets to the global level will have an impact on prices of allowances and thus affects companies' strategies and risk management approaches. Introducing structural changes during the commitment period, or near its start-up, would have a strong impact on the companies that fall under the relevant scheme. Therefore it is of major importance that the actions needed for linking trading schemes must be carried out well in advance of a new trading period, in order to enable companies to revise their strategies and to adapt to the new situation.

Furthermore, a properly working international infrastructure of trading accounts, national registries and international trading hubs is a vital building block of any global emissions market. The International Transaction Log of the UNFCCC is necessary to provide the international administrative clearing function, which is vital for a liquid global market.

#### **D. Project-based Mechanisms**

Our long-term vision for an international emissions trading scheme would cover the vast majority of sources of GHG emissions and emitting countries. This would, in theory, largely avoid the need to continue with additional mechanisms to cover emissions not included within the scheme. Specifically, the adoption of absolute national targets coupled with company-level compliance would remove the need to establish relative, business-as-usual baselines. In such an ideal market, the need for separate project-based credits, such as those established under the Kyoto Protocol (Joint Implementation and Clean Development Mechanism credits) and the associated limitations on the use of emissions trading (e.g. the Commitment Period Reserve) would become superfluous.

In the short term, however, not all countries will introduce clearly defined emissions trading schemes. This will apply especially to developing countries. To ensure that the cost-efficient GHG reduction opportunities in these countries do not fall outside a potential global emissions trading scheme, it is crucial to create a structure that enables optimum realisation of emission-reducing projects in these countries.

Furthermore, there are sectors in the economy in which emissions trading may not be the best way to abate emissions. This could be the case for instance for households and small businesses. To capture low cost emission reductions in these sectors, a project mechanism, linked to the global trading scheme, will still be very useful. Therefore the so-called Linking Directive will remain an important tool for the creation of a global market, which covers more fully a range of emission reduction opportunities.

Currently the use of CDM and JI credits as a transient solution to promote a global emissions trading market suffers from many risks. National authorities may disallow the transfer of credits from the host country, project development may stagnate, projects may generate less emission reductions than foreseen. Moreover, the bottom-up approach of CDM procedures has increased the lead-time for CDM credits considerably and may limit the interest of companies to invest in these projects. These and other barriers to trading undermine both the ability to achieve the required emissions reductions and the ability to do this at least cost. Another main uncertainty for CDM credit sellers and buyers is the development of the International Transaction Log of the UN FCCC. The ITL is planned to be fully operational by April 2007, only 8 months before the end of the 2005-2007 EU ETS trading period. Should the ITL not become operational in time to allow CDM credits to flow into the first EU ETS trading period; the result will be serious CO2-price increases and corresponding adverse effects for European business. To build confidence in the timely development of the ITL, the UN FCCC secretariat should provide periodic updates on the ITL progress during 2006 and 2007.

#### **E. Concrete Proposals for the introduction of stronger links and a more global approach**

##### **E.1**

Linking of project-based mechanisms to the EU ETS is an important first step in establishing a global emissions trading market. To achieve the goal of a world-wide trading scheme the EU should also prepare to link the ETS to other cap-and-trade schemes, as well as similar compatible market-based solutions, as long as they offer a way to sustainable and economically efficient reductions of greenhouse gas emissions. The underlying emissions trading system, the compliance regime and the penalties should be similar in the various regimes linked by any such harmonized (see E.2 below), potentially global emissions trading, in order to avoid market distortion. We recommend avoiding linkages between cap-and-trade systems and trading systems without an absolute cap.

In summary, we recommend that the European Commission and the EU Member State governments **work actively for expanding the coverage of the Linking Directive by instituting links with compatible emerging emissions trading schemes.**

##### **E.2**

It is crucial to develop clear rules for the mutual acceptance of emissions allowances and reduction credits between various schemes worldwide. To ensure a level playing field, the underlying emissions trading systems, the compliance regimes and the penalties should be harmonised as far as possible to avoid market distortion. The principles behind rules for combining different schemes should be clear and transparent to ensure credibility of any unified scheme. In addition, the bureaucracy relating to the linking of schemes should be limited to a minimum to ensure that the cost-efficiency is not counteracted by additional administrative and transaction costs.

Therefore, to make the resulting potentially global market efficient and equally accessible, EFET invites the European Commission to **start elaboration with key international partners of a common set of rules, based on transparent principles, to ensure that all companies from different EU Member States could in future continue to take an active role in an emerging global emissions market.**

### E.3

The EU ETS does not cover all industry and service sectors and thus some cost-efficient opportunities for reducing emissions remain unexplored. This could be corrected by **expanding the approach taken under the Linking Directive to the sectors not covered by the EU ETS**. Industries already within the EU scheme could be encouraged to invest in "intra-EU JI-projects", for example in transport or agriculture. In addition to facilitating new emissions reductions, this approach would ensure that investments in emission reduction are also made for the wider benefit of European society.

Thus EFET invites the European Commission to **analyse the option of enlarging the EU emissions trading markets via EU-internal project-based mechanisms**. EFET also invites key EU Member States to consider using their own laws and measures implementing the Linking Directive to foster, even prior to the 2012 Kyoto review date, **an increase in the interest of those sectors, so far not participating in emissions trading, in project based mechanisms (also known in this context as domestic offset projects.)**

EFET member companies believe it is necessary to aim at, and prepare for, a global market, simultaneously with the continued fine-tuning of the design and rules for just a European market. The momentum for creating a uniform international market can already be felt and should be exploited.