Proposal for a Directive of the European Parliament and of the Council:

Establishing a Framework for Greenhouse Gas Emissions Trading within the European Community

An Analysis of Some Salient Elements

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NOTE FOR THE DOMESTIC EMISSIONS TRADING WORKING GROUP

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The views and conclusions presented in this note are solely those of the author. It does not necessarily reflect the views or the policy of the members of the Domestic Emissions Trading Working Group or their respective Governments.
INTRODUCTION

On October 23, 2001, just prior to the Seventh Conference of the Parties (CoP 7), held in Marrakech October 24th – November 9th, the European Commission (EC) tabled a proposed “Directive” on Emissions Trading for the European Union and its member states. The Directive represents a significant policy move for governments in the EU, signalling a whole sale change in attitudes towards emissions trading from as little as four years ago. Prior to Cop 3, the strongly preferred economic instrument within the Community to reduce carbon emissions was a carbon tax. In fact, it was only the United Kingdom that successfully resisted the imposition of such a tax for the entire European Community. And it was the UK that was the original champion, both within the EU and in the post-Kyoto negotiations, for emissions trading. However, what on the face looks to be a victory in principle for the UK, is in fact a challenge to the viability of the domestic emissions trading system the UK was planning to implement nationally. Nor must it be assumed that the European private sector supports a ‘cap and trade’ – in fact, they are quite divided on this issue, with the German sector in particular strongly opposing it.

The Directive represents an important international milestone for trading in carbon/greenhouse gas emissions. Building on the earlier Green Paper on Emissions Trading commissioned in March of 2000, the Directive now approaches emissions trading as a given for the EU. It’s no longer a question of whether, but of how – should it be driven solely at the national level or at the regional EU level, and if the latter, what would such a system look like?

This note is intended to provide a preliminary analysis of some of the salient features of the EC Directive on Emissions Trading. Areas that will be addressed include:

- the proposed framework for an early emissions trading system (i.e., prior to 2008);
- criteria for evaluating emissions trading programs/allocation within each EU country;
- how other competitiveness issues are being addressed, in particular how it tries to ensure compatibility between the trading instrument and the liberalization of energy markets within the EU;
- linkages to other emissions trading systems, including activities under Articles 6, 12 and 17 of the Kyoto Protocol;
- how to address the possible inclusion of “Accession” or other European countries (such as Norway and Switzerland); and,
- the politics of getting the Directive through the EU/EC process.

This paper will conclude with a summary of those issues that may be of most interest in the Canadian context.
PROPOSED FRAMEWORK FOR AN EMISSIONS TRADING REGIME PRIOR TO 2008

One of the more interesting proposals in the Directive is to recommend that a “preliminary phase” of an internal emissions trading scheme be established for the period between 2005 and 2007. The scheme is characterized by the following elements:

- It is mandatory (all countries must participate) but limited in scope. A relatively limited set of “installations” are identified for participation in the preliminary phase—some 4,000 to 5,000 installations representing some 46 per cent of EU carbon dioxide emissions in 2010.

- Only those installations of a certain size (e.g. only those combustion installations with a thermal input above 20 MW) or character can participate. For example, non-ferrous metals, the chemical sector and waste incineration sectors are all excluded from the preliminary phase.

- This threshold effect undoubtedly carries competitiveness implications—those installations less than 20 MW could have a competitive advantage by not being constrained in the emissions trading scheme. Those installations not covered under emissions trading, should be subject to other policies (tax instruments), even during the preliminary phase.

- Only energy based carbon dioxide emissions are covered in this scheme. To include other greenhouse gas emissions and sinks would be too complicated for at least two reasons: some of those emissions are simply more difficult to track and measure (e.g. methane emissions from landfills) while others (N₂O) are being regulated through other environmental legislation.

- These installations can receive credits (or debits) for their transactions, but these would not be ‘Kyoto’ credits. Instead they would be credits established by each EU Party based on the emission allocations they have set for themselves for the period of 2005 to 2007. In essence, the Directive is proposing pre-Kyoto targets for the above mentioned installations.

- The preliminary phase calls for an allocation of emissions to participating installations on the basis of ‘gratis’ allocation; but one that does also have to fit in with certain criteria that we will discuss in the next section of this paper. The allocation is to be roughly consistent with the Burden Sharing Agreement between EU Parties set out in a Council Decision on June 16, 1998. In other words, while each EU Party is free to choose how many emission units it wishes to allocate to its relevant installations, it must do so on a basis that is consistent with their internal burden sharing arrangement.
Further, in order to determine whether the installation allocations are consistent with the Burden Sharing Agreement, each country would need to have the entire range of policies and measures in place for review. The UK, Germany, Denmark and France have basically completed their implementation plans.

The penalty for non-compliance is set at half the proposed rate for the Kyoto period, but still represents a significant penalty – 50 Euros an excess tonne (CO₂) or twice the expected average market price during the predetermined period (2005-2007).

A preliminary phase was proposed on the assumption that the Community would benefit from a learning experience that would lay the ground work for implementing a fully active emissions trading system by 2008 when the Kyoto commitment period begins. However, there also appears to be some recognition that the experience gained in informing the design of an appropriate emissions trading system by 2008 will be rather limited—it will only have been running for two years, and operators within the Kyoto Protocol will want to know as early as possible what the terms for emissions trading will be during Kyoto.

In fact, it appears that the real rationale in setting up a preliminary phase is to get the private sector and governments more engaged and supportive of the initiative. The actual anticipated pratfalls of a cap and trade system can be most effectively addressed by taking part in it and discovering, from experience, where the opportunities and challenges lie. Hence, the EC has also decided to ‘lower the bar’ in a number of respects so as to entice more active support from the private sector and governments: the penalty rate for non-compliance is half the proposed rate for the Kyoto period; there will be no auctioning of permits; and countries are relatively free (subject to certain criteria) to decide how many allowances they wish to allocate to the relevant installations within their borders.

The Directive also makes it quite clear that the framework established for the preliminary phase should in no way indicate a predisposition to an identical framework in the Kyoto period. For example, while the preliminary phase does not intend to incorporate CDM/JI activities within the preliminary phase, it would be surprising if that state of events were to remain the same for the Kyoto Period. Similarly, there may be some auctioning of permits and perhaps widening of scope of during the Kyoto commitment period.
CRITERIA FOR NATIONAL ALLOCATION PLANS IN THE PRELIMINARY PHASE

While each state in the EU has the authority to decide the quantity of emissions it wishes to internally allocate, the EC has proposed a set of criteria that is intended to meet two goals:

- ensure that the amount allocated by states to the relevant installations is consistent with the EU’s Kyoto commitment;
- ensure that no one sector/industry in one country gains competitive advantage over one in another EU member as the result of a state’s allocation decisions. The criteria are elaborated in Annex III and essentially lay out the parameters under which the EC preliminary phase of the trading instrument will operate.

It is proposed that a Regulatory Committee be established to evaluate whether the criteria are being met. The Committee would be composed of the participating Parties, under the Chair of the EC. It is also proposed that the Committee be a technical body of government experts with the EC, based on the recommendations of Parties, making the final determination on the acceptability of countries’ national trading schemes.

The first criteria speaks to the Kyoto budget period, by noting that “the total quantity of allowances to be allocated for the (preliminary) period shall be consistent with the Member State’s obligation to limit its emissions pursuant….to the Kyoto Protocol.” The wording of this clause is intentionally vague as its goal is to provide the EC as much scope as possible in determining whether a state’s allocation is sufficiently stringent to demonstrate that it is on the path towards meeting its Kyoto target. It is not clear how the EC will make such a determination in the absence of knowing what policies states will be enacting for those sectors outside of the emissions trading scope. It would be a touch simplistic if they were to assume that the relevant installations are allocated emissions in the same neighbourhood of the state’s national target as found in the Burden Sharing Agreement. What if, for example, a country decided that the vast majority of its reductions would come from the transportation sector and leave its utility sector alone? The EC recognizes this and suggests that in making a determination on the appropriateness of a country’s allocation plans under emissions trading, it will be necessary for states to clearly lay out their entire national program in meeting its Kyoto target.

The second criteria represents an elaboration of the first one, clarifying that the amount allocated should reflect the expected rate of progress Parties should be making in meeting their Kyoto targets. This is consistent with a position that the EU has strongly held in the international negotiations—in ensuring that Annex B Parties will be meeting their Kyoto targets, it will be critical to meet the objectives of Article 3.2 of the Kyoto Protocol, which requires Parties to “have
made demonstrable progress in achieving its commitments under this Protocol". Hence, the EC wants to ensure that the amounts allocated respect the spirit and intent of that clause in the Kyoto Protocol.

The third criteria is a rather controversial element, as it seeks to avoid “free riders” or ‘no-regrets’ actions by stating that the amounts allocated “shall be consistent with the technological potential of installations to reduce emissions”. The thinking here is that reductions achieved through no extra effort or expenses should/would occur anyways and hence should not be recognized. Installations, in other words, should in principle be allocated allowances on the basis of their potential and not on their BAU performance. It is highly unlikely that this criteria would be acceptable for at least a couple of reasons: determining technological potential would be extremely difficult (and hence costly) to ascertain and allowances allocated would be significantly reduced, compromising the effectiveness of emissions trading as a means for the EU to reach its Kyoto target.

The fourth criteria is intended to ensure that installations or countries not get away with ‘double dipping’—i.e. claiming credit ‘twice’ for reductions through different programs. In particular, the EC is proposing to ensure that no allowances be allocated to cover emissions which would have been reduced or eliminated under Community legislation on renewable quotas for electricity production. Such a criteria is also likely to meet with considerable opposition and not only from the utility sector. It sets a precedent for avoiding any perceived double dipping which could, for example, have considerable implications for Joint Implementation activities with accession states from Eastern Europe: environmental accession criteria for Eastern European states joining the EU could significantly limit JI opportunities for EU investors such as Sweden and the Netherlands.

The fifth criterion is the critical article for addressing competitiveness issues—it simply states that any national plan for allocation shall “not discriminate between companies or sectors in such a way as to unduly favour certain activities or undertakings”. Thus, while ostensibly EU states have the sovereign right to internally allocate emission allowances, the EC is also determined to ensure that it has the last say in ensuring that states’ allocation decisions do not work to subsidize or favour certain industrial sectors. As envisioned, such determinations would only be made on an ad-hoc, case by case, basis. There may be some pressure to develop a proactive set of guidelines on how Member states should allocate and how to comply with competitiveness criteria in that allocations exercise.

The sixth and seventh criteria call for information on how states will manage new entrants into the trading programme and how states will take early actions into account. In neither case is it envisaged that the EC will be looking to develop further rules in these areas. There may be a case for new entrants having to buy
their way into the market, but for political reasons EC is likely to opt for gratis allocation.

OTHER COMPETITIVENESS ISSUES: COMPATABILITY WITH THE LIBERALIZATION OF ENERGY MARKETS WITHIN THE EU, ENERGY TAXES AND BASIS FOR ALLOCATION DECISION

The Directive makes the argument that emissions trading offers two distinct advantages in complementing energy liberalization over traditional environmental regulations or other policy instruments. In the first place, where an electricity producer is successful in increasing its market share, the installation would have the opportunity to purchase allowances to offset any additional emissions. In the second place, by providing a uniform price and a single market for the carbon tonne, it should work to effectively level the playing field. Of course, that is ultimately determined by the initial allocation, and hence the need, in the eyes of the EC, for a set of common criteria that ensures that no industry or sector is being unfavourably subsidized.

It also notes that if used simultaneously in the same sector, carbon taxes and emissions trading could put an industrial sector at a competitive disadvantage. In that context, without fully retreating (a need to save some face on the part of the Commission), the EC recalls its proposal in 1997 for an EU wide energy/carbon tax and notes that where emissions are covered under emissions trading, the EC proposal would not be relevant for those areas.

A mandatory system was chosen essentially for competitiveness reasons. It was felt that a voluntary regime would not cover sufficient installations and it would be an inefficient means of dealing with competitiveness. Without some sort of system of incentives or penalties, companies would have no reason to join the emissions trading regime. To set up a voluntary regime and then ensure that there is sufficient competitiveness backstops in place for non-participants would be too complex and expensive for a two year trial period.

To a large part the reason that the EC proposed gratis allocation for the pre-Kyoto period rather than auctioning was influenced by auctioning experience with the 3rd generation cellular telephone industry: some governments auctioned off radio signal permits and others simply chose the best bidder. The former resulted in big troubles as many phone companies priced themselves out of the market. UK and Germany now suffer a comparative disadvantage to France which used the beauty contest regime. The lesson for emissions trading is that the allocation process must be harmonized—it can change from gratis allocation to auctioning over time, but it must be harmonized. There still is an active discussion on what is the best scheme, but it was felt that gratis allocation would be the easiest way of getting emissions trading launched in the pre-Kyoto period.
LINKAGES TO OTHER EMISSIONS TRADING SYSTEMS AND PROJECT BASED ACTIVITIES UNDER ARTICLES 6 AND 12 OF THE KYOTO PROTOCOL.

It is the designers’ intent that the EC emissions trading system be compatible with international emissions trading under the provisions of the Kyoto Protocol. Thus the EC, notwithstanding internal pressures to take on strong domestic actions, is keen from the outset to ensure that AAUs purchased through international transactions be integrated into their overall system. Given the explicit reference to the Kyoto Protocol, it would also appear that the EU (no change) would not be interested in pursuing emission trading opportunities with non-Parties such as the US.

Secondly, the system is also intended to be sufficiently flexible to link with other domestic trading systems, particularly those developed within other so called Accession States as well as other members of the European Economic Area, which would theoretically cover Norway, Iceland and Switzerland. In all then, the EC scheme could potentially cover some 30 states. Any such linkages would only be completed once the EC and its Party members are satisfied that the allowances generated in other emissions trading systems were sufficiently credible and robust. The particular proposal for a benchmark of 20 MW for energy related activities would work to exclude Norway from participating in any such scheme as its installations (off shore drilling sites) all work under the 20 MW benchmark. Hence, some have criticized the EC for not carefully examining the extent to which the parameters of participation in their emissions trading scheme would accommodate the domestic emissions trading schemes of Accession states or others in the European Economic Area.

The extent to which establishing such a system will actually work to press other countries completely outside the EU area to link their domestic emissions trading system with the EU’s DET also needs to be considered. When one considers that the US in all likelihood will not ratify the Kyoto Protocol, then the EU system will likely carry considerably more weight in the commercial emissions trading market. Other countries such as Canada and Japan may end up being under some pressure to coordinate/harmonize their domestic emissions trading schemes with the one developed by the EU. And the EU may be able to carry enough weight as a buyer that it may insist on certain guidelines/practices for potential sellers such as Russia. At this point, one can only speculate on such matters but clearly these are issues which warrant Canada’s continued attention.

IMPLICATIONS FOR BANKING INTO THE KYOTO COMMITMENT PERIOD

While it is not explicitly addressed in the document, it has since been clarified that countries have the option to allow installations under this plan to ‘bank’ any surplus allowances from the pre-Kyoto commitment period towards
their Kyoto commitments. However, as with all allocation decisions at the national levels, any such scheme would have to be reviewed and accepted by the Regulatory Committee to ensure that such actions do not compromise a country’s ability to meet its obligations under the Kyoto Protocol. It will be important for countries that do allow for such banking to make sure that their pre-Kyoto national allocation is sufficiently stringent to ensure that its emission reductions targets under Kyoto are on track.

THE POLITICS OF GETTING THE PROPOSED DIRECTIVE APPROVED

Any initiative such as this will clearly require careful negotiations – initially amongst members of the EU and then other prospective members, comprising Accession states (Eastern European countries who are on track to join the EU over the next few years, including Poland, the Czech Republic, Hungary, Romania, etc) and members of the European Economic Area (including Norway, Iceland and Switzerland). Within the EU, the challenge will come from three sources—those countries such as the UK which have already developed their own national emissions trading systems; countries such as Germany whose industrial sectors have strong concerns about an emissions cap and trade regime as an appropriate policy instrument in addressing climate change; and Cohesion states such as Spain, Greece and Portugal which have yet to develop internal regimes that would demonstrate that they are committed to seriously tackling the challenge of climate change mitigation.

Regarding the former, an interim agreement has been reached with the EC whereby the UK has been provided a ‘green light’ to implement its voluntary based national emissions trading regime. The UK scheme is planned to be launched in 2002 and conclude by 2007 with currently no provision for a national emissions trading based system for the Kyoto period. While the UK proposal has been approved, there is also an understanding that should an EU trading instrument be in place prior to the Kyoto commitment period, then negotiations will need to occur between the UK and the EC on how the UK system would be revised to accommodate the EU wide system. It needs to be kept in mind that since the EU wide system is not envisioned to be place until 2005 there may be an opportunity for an arrangement with the UK for a ‘transitional period’ for the UK’s voluntary system to evolve into a mandatory regime in time for the Kyoto commitment period of 2008 to 2012.

In addition, there are still many sceptics in industrial sectors throughout Europe regarding an allowance based emissions trading regime. Not unlike potentially targeted sectors in the Canadian economy, the concern is that a cap and trade system would actually work to limit, rather than accommodate, the potential of those industries to expand their operations and investments. This concern is particularly pronounced in the pivotal country of Germany. While the current Schroeder government is sympathetic to exploring emissions trading as
an appropriate economic instrument, it needs to be kept in mind that the European tradition of designing voluntary agreements or covenants between governments and industry on, for example, energy efficiency/renewable quotas is a regime with which European industry has considerably more experience. The problem for governments is that such agreements, more often than not, address unit based growth rates and not absolute caps which drive the Kyoto regime. One has only to look at what is currently happening in the Netherlands, where industrial sectors continue to more than meet voluntary based covenant agreements on energy efficiency rates but absolute emissions continue to grow due to strong growth in the Dutch economy.

Finally, it should be noted that the extent to which so called Cohesion states support emissions trading will be determined by the willingness of other EU members/EC to cover the costs of establishing such a system, including developing its national plans. If they were to rely only on their own resources it is doubtful whether they would be able to design and implement a system in time for the 2005 period.

CONCLUSION—ISSUES OF RELEVANCE/INTEREST IN THE CANADIAN CONTEXT

In summary, the following observations/conclusions on the part of the EC designers may be of interest to those considering the design of an emissions trading regime for Canada.

- Gratis allocation may be an effective means of initially engaging critical industry sectors and other actors in considering an allowance based emissions trading system.
- A lesson from other auctioning exercises suggests that unless carefully managed the regime could easily unreasonably stretch costs for emissions trading participants.
- Any gratis/grandfathering scheme would need to be accompanied by a set of criteria that would work to ensure that no one region/sector has a competitive advantage and that the relevant sector/region is making the appropriate contribution in reaching the Kyoto target.
- A voluntary scheme carries the additional burden of needing to develop an incentive package of some sort (state subsidy for participants or additional penalty for non-participants) that ensures that every one competes on a level playing field.
- Emissions trading is a fiscal instrument that would complement energy liberalization initiatives on a regional basis.
- An early emissions trading regime may be an effective way of providing practical experience to those who would need to participate in such a regime.
during the Kyoto period. It will also work to provide an additional incentive for countries to develop their overall national plans in a timely and early fashion.

- The value of the allowances in such an early regime will be based on the gratis allocations provided for by each country. Each government has the right to allow for banking into the Kyoto commitment period but, under such a scenario, it would need to ensure that its gratis allocations were sufficiently stringent to ensure that its country is on track to meet its Kyoto target.

- Again, in the interests of initially establishing as simple an emissions trading system as possible, consideration should be given to limiting the scope of what activities emissions trading would cover. This would include no current provision for linking it with international project based offset activities, such as the CDM and JI.

- However, the ‘keep it simple approach’ will only be credible as long as other sectors/activities/gases not covered under emissions trading are accounted for in some other manner. In other words, a comprehensive national plan on meeting greenhouse gas reduction targets needs to be in place to ensure that both competitiveness and environmental integrity are respected.