REVIEW OF THE EU EMISSIONS TRADING SCHEME

MAIN FINDINGS OF A CEPS TASK FORCE

FOR DISCUSSIONS IN THE COUNCIL OF MINISTERS & EUROPEAN PARLIAMENT ON THE COMMISSION’S PROPOSAL

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These Main Findings are based on discussions in the CEPS Task Force on Completing the Review of the EU Emissions Trading Scheme, which met four times between October 2007 and September 2008. Participants included senior executives from a broad range of industry – including energy production and supply companies, energy-intensive industries and service companies – and representatives from business associations, environmental NGOs, academic experts and government representatives. A full list of members and invited guests and speakers appears in the Annex.

The members of the Task Force engaged in extensive debates in the course of several meetings and submitted comments on earlier drafts of this report. It reflects the general tone and direction of the discussion, but its recommendations do not necessarily reflect a full common position agreed among all members of the Task Force, nor do they necessarily represent the views of the institutions to which the members belong.
PREFACE

The EU emissions trading scheme (EU ETS) is the flagship climate policy tool of the EU. The scheme was up and running in a relatively short time period and this is a success in itself. The ETS is an important element of the emerging global carbon market and by linking to the Clean Development Mechanism (CDM) and Joint Implementation (JI), the system has global reach. Moreover, the ETS has become a reference point for other countries’ initiatives to develop emissions trading schemes. The initial phase of the EU ETS has not been without problems, however, as has been amply documented. The first period was a learning-by-doing phase. The review and subsequent proposals for revision are preparing the ETS for the post-2012 period.

It has been my privilege over the past year to chair the CEPS Task Force on the EU ETS Review with a view to providing policy recommendations, first to the European Commission, then to the European Parliament and the Council of Ministers and also to other stakeholders. The work was made possible thanks to the members of the Task Force, including a wide range of business, industry, research and environmental NGOs, who gave their expertise and time, presenting the viewpoints of different interests. The Task Force is particularly indebted to Felix Matthes and Joachim Schleich, who by contributing their research findings, have set the scene for the Task Force discussions. I would also like to thank the European Commission and member state officials who generously shared their expertise and reflections and, through their contributions and advice, helped us to remain focused on what soon became a rapidly emerging agenda. Last, but not least, we were fortunate enough to be able to rely on CEPS’ support throughout the Task Force.

This CEPS Task Force Report was designed as a general reflection on some of the most controversial issues under review against the objectives of the EU ETS, i.e. to reduce greenhouse gas emissions in a cost-effective manner. While identifying a number of key principles to which any future EU ETS should adhere, the CEPS Task Force identified several key measures crucial to a future successful climate policy in the EU.

Discussions were always rich, the debate was at times intense and I believe that this Task Force has made a constructive contribution to one of the most important policy questions in Europe and beyond.

Ulrika Raab
Chair of the CEPS Task Force
Senior Advisor, Swedish Energy Agency & Member of the CDM Executive Board
In January 2008, the European Commission, in the context of the integrated energy and climate package, tabled a proposal to amend the EU emissions trading directive. The proposal is currently under discussion in both the Council of Ministers and the European Parliament, together with the other elements of the ‘Package’. It is expected that an agreement can be reached by early December 2008.

The findings of this report are based on a CEPS multi-stakeholder Task Force that has focused on the ‘principles’ that the Council of the European Union and the European Parliament should respect in their review of the EU emissions trading scheme (ETS). It examines some of the more controversial arguments made against the purpose, main principles and functioning of the EU ETS as well as other parts of the package.

The report covers the following issues: the international dimension – the impact on third countries, CDM (clean development mechanism) linking and international finance issues – and competitiveness and carbon leakage, including EU finance issues.

Background Analysis and Key Messages

The carbon price signal and its limitations

1. Since the adoption of the EU ETS Directive in 2003, a large consensus has emerged in the EU to use carbon pricing in the form of emissions trading, i.e. a cap-and-trade scheme, as the foundation for its climate policy. If properly designed, the EU ETS cap-and-trade scheme will create incentives for companies to reduce emissions in the most cost-effective way, will reward carbon-efficiency and create incentives for new and innovative approaches to reduce emissions. The incentive for efficient abatement will arise from the ‘opportunity cost’ of using allowances. Passing through the greenhouse gases (GHG) costs in the form of an allowance price will create a consumer incentive to reduce the use of GHG-intensive goods. At the same time, it will increase producers’ cash flow to invest in abatement technologies. In a situation whereby all competitors are subject to similar carbon constraints and markets function properly, the EU ETS would be the most suitable tool to achieve EU and UN-based targets at the lowest possible cost. The price signal will be distorted, however, if GHG costs cannot be passed through domestically or globally. In this case, the market structure, especially price elasticity of demand, inhibits globally-trading industries’ ability to pass-through fully or even partially. As a result (European and global) product prices will not reflect the ‘opportunity costs’ of allowances and therefore the EU cost of carbon. For example, if firms in a European industry cannot pass through the
allowance price partly or fully, it is these firms in the industry that eventually end up ‘paying’ for the allowance price it cannot do so itself. Failure to pass through would erode benefits from CO₂ abatement as well as producers’ competitiveness, transfer allowance value abroad, and ultimately lead to carbon leakage.

The EU ETS review in the international context

2. Success of the EU ETS review is critical to the development of a comprehensive global climate change agreement beyond 2012. An environmentally effective and economically efficient revised ETS constitutes an important demonstration that GHG emission reductions can be achieved in a cost-effective manner and without damaging industry.

3. The EU has attempted to address large differences in economy structure and income levels between countries within a package deal with the aid of existing methodologies that deal with such differences. This could be regarded as an interesting example by third countries and international organisations with a view to advancing the UN negotiations.

4. No matter how detailed the criteria to trigger a move to a 30% reduction would be, there will always be a need to retain a degree of ambiguity on what a post-2012 ‘agreement’ that is acceptable to the EU means, to avoid revealing the EU’s negotiation position. However, a number of criteria that such a post-2012 agreement will need to fulfil can be formulated now. Provisions will need to be monitorable, reportable and verifiable with credible enforcement at the national or international level as well as the existence of certain parameters for governments or intergovernmental organisations to compare efforts of especially, but not only, globally trading companies.

5. The EU ETS will be looked at closely as a source of possible financial incentives for developing countries by other parties in the UN negotiations. However, the EU ETS is only one of many sources of potential funding. Holding out the prospect of EU funding from the EU ETS for developing countries will send an important signal to developing countries. Committing exact figures will unnecessarily reveal the EU’s negotiation position.

6. Linking effective and efficient emissions trading systems is a key element in the expansion of emerging carbon markets. The proposed directive has added an innovative element to facilitate linking through the acceptance of allowances from other trading schemes, if done on a reciprocal basis. However, there is a risk of undermining the value of this clause by setting too many additional requirements as a precondition for linking.

7. As formulated under UNFCCC rules, the CDM is successful and works reasonably well, not least in building capacity in developing countries. This should be recognised when the EU discusses qualitative and quantitative restrictions. Qualitative restrictions of the CDM imposed by the EU aim at ensuring a certain environmental benefit. Quantitative restrictions are a means of finding a balance between domestic action to move the EU onto a low-carbon trajectory without damaging EU industry on the one hand, and providing
incentives for (CDM) project development, thereby fostering the emerging global carbon market on the other. The current CDM as an offsetting mechanism has a potential to grow even further. In the long term, however, as a broader range of countries accept different types of targets, it is likely that the CDM will be transformed into other market-based instruments or national policies and measures. A CDM ceiling in the ETS causes important problems for the short-term development of new CDM projects stretching beyond 2012 and for the potential long-term transition of CDM into new ‘post-2012 mechanisms’. Regardless of how the trade-off of the above is settled politically, it is important that the EU works within the UNFCCC negotiations to improve the environmental effectiveness, efficiency and thereby the credibility of the CDM. This should also allow for a possible extension or scaling up of the CDM and other possible mechanisms in the post-2012 agreement, enhance the engagement of developing countries and foster technology transfer, as well as the development of the global carbon market.

Competitiveness and carbon leakage

8. Carbon leakage has been defined by the IEA as the ratio of emissions increase from a specific sector outside the country (as a result of a policy affecting that sector in the country) over the domestic emission reductions in the sector (again, as a result of the domestic environmental policy). A distinction is made between short-term competitiveness impacts (e.g. loss of market share) and longer-term impacts on investment.

9. Overall the risk of carbon leakage from direct impacts appears to affect only a relatively small section of EU GDP directly. But impacts are most likely to be felt on a regional, sectoral and installation level. In addition, there may be knock-on effects for the downstream supply chain of affected industries. Furthermore, the risk of carbon leakage due to investment leakage is difficult or impossible to assess by existing macro-analysis data, which are often unable to single out different factors influencing investment decisions. In the absence of agreed methodologies and given uncertainties on carbon price developments and the emergence of a global agreement, robust criteria are required to assess the risk of carbon leakage. These criteria will need to take into account, for example, the ability to pass through CO₂ costs, market structure, trade intensity of raw materials and final goods or transport costs including the indirect effects of increasing input (e.g. power) prices. The actual effects will only be known ex-post.

10. Although the European Commission proposal mentions three potential ways to address carbon leakage – free allocation, border measures and sectoral agreements – preference is given to free allocation as potentially the simplest and most politically feasible solution. Free allocation can compensate for the additional CO₂ costs stemming from direct emissions that cannot be passed through in the absence of a global agreement. However, indirect effects, for example as a result of increasing power prices, would need to be addressed by other mechanisms. Different mechanisms are currently discussed, including cash compensation or the allocation of free allowances (based on power consumption). Such compensation is preferably addressed by measures that would easily be
revoked when the need for them disappears (i.e. in case of a global agreement). An important link between the EU ETS and such solutions are possibly the receipts that would arise from the auctioning of allowances to sectors that can pass through their carbon costs. Such compensation measures would ease the carbon price signal in some ETS sectors at least to a degree, shifting the reduction obligation to other parts of the economy that potentially have higher abatement costs. If so, this would increase the costs of achieving climate objectives from an overall EU economic point of view.

11. If free allocation is used as a solution, it must be fair and provide signals to industry to reduce GHG emissions. If benchmarks are used, they must be EU-wide and limited in number. They would need to take into account scientific-technological barriers to reduction and time scales to invent and install breakthrough technologies.

12. For sectors that can fully pass on the opportunity costs of CO₂ allowances, there is no need for such measures. To avoid windfall profits and to generate extra revenues for governments to use for climate-friendly policies, full auctioning would appear to be the allocation instrument of choice. Once there is a global agreement that puts EU’s industry’s competitors under ‘comparable’ carbon constraints, all industries will increasingly be able to pass through carbon costs and the need for compensation will disappear.

**Recommendations for the EU ETS Review**

Against the background of the above analysis, the multiple stakeholders who participated in the CEPS Task Force identified the following principles to guide the European Parliament and the Council in their review of the EU ETS.

**Potential of the EU ETS**

1. An environmentally ambitious and economically efficient new EU ETS that can safeguard competitiveness is likely to facilitate the introduction of emissions trading schemes outside the EU, the accelerated development of a global carbon market and possibly a global climate change agreement.

2. Economic efficiency and environmental effectiveness would be well-served if politicians abstain from using the EU ETS to deal with unrelated issues, such as regional disparities, re-distributional or social policy objectives.

**The EU ETS review in the international context**

3. With a view to advancing the UN negotiations, the EU could show third countries and intergovernmental organisations an example of how to address large differences in economy structure and income levels between countries within a package deal, with the aid of existing methodologies that assess such differences.

4. It is too early to identify all criteria to trigger a move to a 30% reduction target without revealing the EU negotiation position. A number of conditions that a post-2012 agreement would need to fulfil can already be listed now. These
include the need to monitor, report and verify with credible enforcement at national or international level and the existence of certain parameters for governments or intergovernmental organisations to compare efforts.

5. The EU should indicate in the ETS Review the possibilities for generating significant funding from the EU ETS and transferring it to developing countries, without providing detailed figures or breakdowns so as not to undermine its negotiation position.

6. The EU should not preset conditions for linking the ETS and should deal with the different design options adopted in other schemes when the compatibility issue arises.

Clean Development Mechanism (CDM)

7. Any EU decision should recognise the fact that the CDM has been a success and is working reasonably well.

8. The EU should work within the UNFCCC negotiations to improve the environmental effectiveness, efficiency and thereby credibility of the CDM.

9. Any decision on the CDM should not prejudice a possible extension or scaling up of the CDM or other possible flexible mechanisms in the post-2012 agreement.

10. The CDM and other ‘post-2012 mechanisms’ will be crucial to engaging developing countries and bringing them onto a more sustainable development path, towards technology transfer and the development of the global carbon market.


12. The EU decision should not prolong uncertainty about the CDM.

Competitiveness and carbon leakage

13. The assessment of the risk of carbon leakage should be based on criteria that have been submitted to a stakeholder review. In particular it should include both direct and indirect effects (e.g. through electricity prices), regional impacts, impacts on the downstream supply chain and provide for the inclusion of changes over time of the way sectors operate.

14. Free allocation can compensate for the additional CO₂ costs stemming from direct emissions. Whether indirect effects can be addressed in this way remains uncertain at this stage. How indirect effects can be best compensated also needs to be investigated further.

15. If free allocation is used as a solution, it should be based on benchmarks and actual exposure to the risk of leakage. Such benchmarks, however, must be limited in number and be EU-wide. They should be ambitious but take into account the scientific-technological barriers to reduction and allow for realistic time scales to develop and install breakthrough technologies.
# ANNEX

## Members of the CEPS Task Force and Invited Guests and Speakers

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**Research Networks/Joint Initiatives**

- Changing Landscape of Security & Liberty (CHALLENGE)
- European Capital Markets Institute (ECMI)
- European Climate Platform (ECP)
- European Credit Research Institute (ECRI)
- European Network of Agricultural & Rural Policy Research Institutes (ENARPRI)
- European Network for Better Regulation (ENBR)
- European Network of Economic Policy Research Institutes (ENEPRI)
- European Policy Institutes Network (EPIN)
- European Security Forum (ESF)

CEPS also organises a variety of activities and special events, involving its members and other stakeholders in the European policy debate, national and EU-level policy-makers, academics, corporate executives, NGOs and the media. CEPS’ funding is obtained from a variety of sources, including membership fees, project research, foundation grants, conferences fees, publication sales and an annual grant from the European Commission.

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