The EU Proposal for Emissions Trading: A Reasonable Approach?

Pro: Emissions Trading for Efficiency, Environmental Protection and Equity: The Cornerstone of EU Climate Policy

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Climate policy – a task for generations

Global climate policy has gained prominence in the last decade and culminated in the negotiation of the Kyoto Protocol. It defines legally binding greenhouse gas reduction targets for industrialised countries and some countries in transition in the "commitment period" 2008 to 2012. They are likely to be strengthened subsequently in response to long-term reduction needs. In spite of being referred to as "dead" by many stakeholders, the Kyoto Protocol is alive and kicking and likely to enter into force within the next year. Industrialised countries will then face the challenge of implementing a policy mix that minimises overall compliance costs for their national economies. In a surprising move that made a lot of American observers envious, the EU has become a pioneer in emissions trading in less than three years.

Two birds with one stone: efficiency and environmental protection through emissions trading

While being a frontrunner in suggesting stringent targets, the EU's performance in introducing far-reaching policy instruments has been disappointing as the slow burial of a common CO_2-/energy tax shows. After one decade of ad hoc policies and reliance on the historical accidents of German reunification and the British "dash for gas", it dawned on the Commission that current national policies would not reach the EU's Kyoto commitment. In a courageous U-turn the Commission decided that an internal emissions trading system for large emitters provided the only powerful and effective alternative to an emissions tax.

Efficiency demands mandatory participation, as in a voluntary system only those emitters can be expected to participate who see themselves in a seller's position[1], hence no market would emerge. The direct inclusion of entities – be it installations or companies – in emissions trading has several advantages:

1. Emissions trading directly targets absolute GHG-emissions, whereas emissions and energy taxes as well as efficiency standards only have indirect effects. Thus, governments would not have to follow a "trial-and-error-process" to reach their Kyoto target.

2. Entities can evaluate their internal reduction potential much better than government. The cost of emissions allowances will provide a clear and simple incentive.

The inclusion of the Kyoto Mechanisms will further and significantly reduce costs. Whereas price estimates for a purely internal market range between 18 and 33 €/t CO_2, forecasts for world market prices range from 2 to 8 €/t CO_2. The World Bank's Prototype Carbon Fund pays about 3.5 €/t for millions of tons of CO_2.

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[1] Unless excessive (financial) incentives are provided.

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Equity: Can the third dimension of the trading scheme be managed in the EU?

Surprisingly, resistance to emission trading has come from industry stakeholders traditionally in favour, mainly in Germany. It may be due to the fear of absolute emissions targets and comparative disadvantages, particularly compared to the United States. However, many US companies call for clear, long-term climate policy perspectives. Already several regional GHG-emission trading schemes have been set up.

Under grandfathering, the ex-ante-costs for participants will be close to zero. The draft directive does not require any concrete allocation formulas and sets only broad criteria. National governments thus have the freedom to consider special national circumstances, be it on the industrial or sectoral level. Existing voluntary agreements can build the basis for national allocation.

Contra: Many Open Questions

Günter Roeder*

After the EU Council of Environment Ministers endorsed the Directive on Emissions Trading in December 2002 the contra position seems to have been consigned to history. Roma locuta, causa finita (Rome has spoken, the campaign is over), emissions trading is coming anyhow. Nevertheless, many questions which would warrant further discussion remain open.

In order to set out the historical record one last time the following should be noted. The chemical industry has never formulated a contra position on environmental conservation and on the careful husbanding of energy but rather adopted from the outset a clear pro position on ecological and economic grounds. Thus, the European chemical industry set a target to reduce CO_2 equivalents by 30 percent from 1990 to 2010. In Germany the chemical industry has already lowered its energy-related emissions by 33 percent between 1990 and 2001. By 2012 it aims to reduce specific energy consumption by 35 to 40 percent and to achieve absolute reductions in greenhouse gases causing global warming (CO_2 equivalents) of 45 to 50 percent.

- The directive still involves considerable risks for the affected companies. These threats do not arise from trading in CO_2 certificates but rather from the upper CO_2 limits which each EU Member State must lay down for plants. The directive indeed allows great freedom in the organisation of national allocation plans for CO_2 certificates. But, in fact, the allocation has to be made in compliance with the national burden-sharing targets of the EU. Germany has committed itself to an absolute reduction of all CO_2 emissions of 21 percent with respect to the base year, 1990. In reaching their burden-sharing targets the EU and its Member States are confronted with enormous challenges. Only the United Kingdom and Germany are well on the way to fulfilling their quotas.
- German industry will not be *the* vendor of certificates to other EU states. Although it has achieved substantial reductions, these are counterbalanced by unchecked emissions in the household and transport sectors. The German federal government will have to take this into account in accordance with the provisions of the directive when drawing up the national CO_2 allocation plan.
- Individual EU states have already declared their intention of buying CO_2 certificates on the international market in order to protect the competitiveness of their companies. However, neither in the EU nor globally are procedures and financing methods for this purpose regulated. A mandatory requirement of companies for emissions trading with third countries, however, is that international agreements have been concluded.
- The de facto objective of the directive is that many of the companies covered by the directive must buy CO_2 certificates in order to maintain production. They will certainly need to buy even more certificates if they wish to continue growing. Since the EU Commission has already estimated the costs at € 20 to 33 per metric ton of CO_2, the producing industry is threatened with considerable additional costs.
- There is a further risk in that companies which aim to or have to avoid additional costs will shift their investments to third regions which have either not ratified the Kyoto protocol or have no reductions imposed on them by the Kyoto protocol. As a result, global CO_2 emissions would not drop, the sources of CO_2 would only be shifted from one region to another. This would provide no remedy for the environment, either in Europe or globally. The EU would only look better in the CO_2 statistics.

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