

THE EUROPEAN UNION GREENHOUSE GAS EMISSIONS TRADING SYSTEM An Overview

DEVELOPING AN EMISSIONS TRADING SYSTEM IN THE EUROPEAN UNION

Created in conjunction with the Kyoto Protocol, the European Union Emissions Trading System (EU ETS) is the largest multi-national, greenhouse gas (GHG) emissions trading scheme in the world. The program was developed and implemented in record time — within two years after the legislation was adopted — and is the world's only operating mandatory greenhouse gas emissions trading program.

The Center for Clean Air Policy (CCAP) advised the EU and developed recommendations that ultimately formed the basis for the EU ETS.

HOW THE EU ETS WORKS

The EU ETS began operating in January 2005, and all 27 member states of the European Union participate. The EU ETS is one of the key elements of the EU's strategy to meet its emissions reduction target under the Kyoto Protocol and its post-2012 reduction commitments — to reduce emissions by 20-30 percent below 1990 in 2020.

- The program caps — or limits — the amount of GHG emissions from large companies and industries and covers almost half of the EU's carbon dioxide emissions. The system currently **covers more than 11,500 energy-intensive installations across the EU**, including power plants, oil refineries, coke ovens, iron and steel, cement, glass, lime, brick, ceramics, and pulp and paper facilities. The trading system has two phases: 2005-2007 (the “learning-by-doing phase”) and 2008-2012 (the “Kyoto phase”).
- The sector and facility caps (the “allowances”) are based upon a National Allocation Plan (NAP) developed by each member state, and the European Commission either approves them or requires modifications. The country can then accept the recommendations and implement the caps or submit a revised NAP for Commission approval. A final NAP is published for each country and its facilities. The second phase NAPs (covering the 2008-2012 trading period) have been adopted for most countries.
- EU member states have far more autonomous power in a more decentralized system than states in the U.S. Consequently, **the EU Commission had to move more carefully toward a federal solution**, especially for the NAPs. The first phase NAP process resulted in an excess allocation of allowances, due to lack of reliable data and other factors. As a result, when actual reported data became available, the price of allowances in the first phase dropped significantly. As the learning-by-doing phase ended and more reliable data became available, the second phase NAPs are considerably more stringent.
- **The majority of allowances are given to facilities for free.** In the first trading period, a minimum of 95 percent of the total amount of allowances is allocated for free, a practice commonly referred to as grandfathering. In the 2008-2012 period, the grandfathered amount will equal 90 percent of allowances, and the amount of auctioned allowances could rise to 10 percent. Because industries receive most of their permits for free and the

price of carbon included in the allowances results in higher consumer costs, industries are able to generate greater profits. This is known as “windfall profits,” which has been a criticism of the EU ETS.

- Allowances traded in the EU ETS are not printed, but rather held in accounts in electronic registries set up by Member States. A Central Administrator at the EU oversees all of these registries and, through the community independent transaction log, checks each transaction for any irregularities. This way, the registries system keeps track of the ownership of allowances in essentially the same way a banking system keeps track of the ownership of money.

AN EVOLVING SYSTEM: ONGOING IMPROVEMENTS AND MODIFICATIONS

During the first phase, the EU acknowledged that some glitches would occur; however, given the urgency presented by the increasing effects of global climate change, it agreed that a system needed to be put in place, but that the first phase would be learning-by-doing. **The EU has carefully monitored those glitches and has made modifications for the second — and internationally binding — phase of the program, which begins in 2008.**

Additionally, the EU Commission will make recommendations on suggested revisions to the EU ETS for the post-2012 phase later in 2007. A number of key issues are under consideration, including: more harmonization of the NAP process across the countries; a larger amount of auctioning; and inclusion of other sectors/gases. Final revisions to the system will then be translated into EU law and included in the post-2012 phases of the program. Furthermore, deliberations are being undertaken on the post-2012 caps for the EU ETS sectors as a part of the overall effort to reduce EU emissions by 20-30 percent below 1990 levels in 2020.

A NEW OUTLOOK ON AND TREATMENT OF CARBON

The first phase of the EU ETS has established a very strong carbon market. One of its most significant impacts is how companies in the EU now treat carbon emissions. Before the program was implemented, the price for emitting carbon was zero. Now, companies across Europe are examining their carbon emissions, paying a price for emitting carbon into the atmosphere and incorporating the cost of carbon into their long-term planning. This new outlook on and treatment of carbon will lead to an overall reduction in emissions.

For more information about the EU ETS, please contact Jake Schmidt, manager of International Programs at jschmidt@ccap.org.

Since 1985, CCAP has been a recognized world leader in climate and air quality policy and is the only independent, nonprofit think-tank working exclusively on those issues at the local, national and international levels. Headquartered in Washington, D.C., CCAP helps policy-makers around the world to develop, promote and implement innovative, market-based solutions to major climate, air quality and energy problems that balance both environmental and economic interests. More information about CCAP can be found at www.ccap.org.

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