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Summary Paper | European Union Emissions Trading Scheme

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Overview

The EU has taken a decision to improve and extend the EU Emissions Trading Scheme (ETS). The European Commission proposed a series of changes to the ETS, which were agreed by EU member states - though with some significant amendments – and passed by the European Parliament. New legislation has now been adopted[1] and the changes will take effect in 2013 (Phase III of the ETS).

Overall, the aim is to create a better-harmonised EU carbon market by setting a single EU-wide cap on allowances that reduces year-on-year, and removing discrepancies between national methods of allocating allowances. The result should be greater clarity, credibility and predictability in the carbon market.

Emissions from those sectors covered by the ETS will be cut by 21% by 2020 compared with 2005 levels. A single EU-wide cap on ETS emissions will be set, and free allocation of emission allowances will be progressively replaced by auctioning of allowances. Under the new system over 40% of total EU emissions would be covered by the ETS.

Key changes

1. One EU-wide cap on the number of emission allowances instead of 27 national caps. The annual cap will decrease along a linear trend line (by 1.74% per year)[2].

2. The free allocation of allowances will be governed by a single set of rules across the EU.

3. The percentage of allowances to be auctioned will be much higher than to-date. The Commission predicts that revenues from auctioning could reach €50 billion annually by 2020.

4. There will be full auctioning of allowances for the power sector (except for specially-exempted plants heavily dependent on coal – see below – and some CHP). Auctions will be open: any EU operator will be able to buy allowances in any member state. For other sectors, a reducing scale of free allocations starting at 80% free and gradually reducing to zero will operate (except for those industries granted derogations – see below).

5. 88% of allowances to be auctioned will be divided up based on countries' emissions (according to a 2005 baseline) and the remaining 12% will be allocated to take into account distortions in wealth

1 The European Council (EU governments) must approve the legislation before it finally enters into force.

2 Current allocation procedures vary widely across the EU, threatening fair competition. The system of National Allocation Plans (NAPs) will cease to operate, as there will be one harmonised system. Allowances remain valid throughout the trading period and any surplus allowances can now be "banked" for use in subsequent trading periods.

across the EU.

6. At least 50% of auction revenues will be used for mitigation, adaptation, development of renewables, forestry projects and to cover administration costs.[3]

7. The range of industries covered will be expanded (e.g. to include aluminium and ammonia producers). Carbon capture and storage will also be included.

8. N_2O and perflourocarbon emissions will be included for certain industries.

9. Member states may exclude small installations, provided they are subject to equivalent emission reduction measures.

These changes were agreed by EU heads of government in a deal that watered down the European Commission's original proposals in four respects:

- Certain power generators, particularly those in Eastern Europe that are heavily dependent on coal, will continue to receive free allowances beyond the originally-proposed full auctioning date. However, free allowances must not exceed 70% of affected member states' national allocations in 2013 and must be phased out by 2020, with affected member states committing to modernise their electricity sectors;
- For other sectors, full auctioning must now be implemented by 2027 (rather than by 2020 as in the Commission's original proposals);
- Industries heavily susceptible to leakage (i.e. re-location outside the EU to avoid the costs of the ETS) will be given free allowances, and the Commission estimates that over 90% of manufacturing emissions could be exempted in this way[4];
- The amount of carbon credits that may be used is increased.

These amendments reflect the concern of many member states that the new ETS regime would be highly damaging to EU economies already battered by the current financial crisis.

The use of Carbon Credits

Operators in the ETS will be able to use credits from JI and CDM projects (ERUs and CERs) in the same way as allowances. However, only unused credits from the 2008-2012 ETS phase will be accepted[5]. Up to 50% of reductions may be achieved through CDM/JI projects (this is an increase from circa 30% as proposed by the Commission).

The EU is committed to increasing its emissions reduction commitment from 20% to 30% of 1990 levels by 2020 provided global agreement is reached on comparable reductions for other developed countries. In this event, the number of CERs/ERUs permitted to be used in the ETS would increase by half of the additional reduction commitment. (E.g. if the ETS cap were reduced by 100 million tCO_2, the limit on the use of CERs/ERUs would be increased by 50 million credits.)

3 The Commission had originally proposed that only 20% of revenues be used in this way.

4 The Commission will determine which sectors may be exempted from auctioning by 31 December 2009 and will review this 5-yearly thereafter. Installations will only be exempted as long as this is 'necessary and proportionate'.

5 According to the Commission, prior to a global agreement being reached, any increase in the use of credits above those granted for 2008-2012 would reduce incentives for companies to invest in carbon-efficient technologies and thus risk undermining the achievement of sufficient domestic emission reductions to achieve the 2020 target.

Within EU member states, emissions reduction projects not covered by the ETS could also issue credits. These 'domestic offset credits' would be managed by common EU provisions in order to be tradable throughout the system and to avoid double-counting.

Credits from land use, land-use change and forestry (LULUCF) projects will not be accepted in the ETS. The Commission believes that there is too much uncertainty surrounding the permanence of emissions reductions and potential emissions leakage, and that the liability risks for member states would be too great.

Aviation

The EU recently passed legislation to include aviation in the ETS from 2012, establishing that the aviation industry will receive an allowances allocation equivalent to 97% of its 2005 emissions and 95% from 2013. All flights to, from or within the EU are covered, regardless of airline nationality. Airlines will receive 85% of their emission allowances for free in 2012. This percentage may be reduced from 2013. Commercial air operators with low traffic levels or with low emissions (< 10,000 tCO_2 a year) will be exempt. In practice, this means many operators from developing countries will be exempt. The Commission will also draft proposals for reducing N_2O emissions from aircraft.

Non-ETS emissions reductions

Emissions from sectors not included in the ETS – e.g. transport, housing, agriculture and waste – are to be cut by 10% from 2005 levels by 2020, under a series of binding national targets. Each member state is to contribute according to its relative wealth, with national emission targets ranging from -20% to +20%.

Timeline

2005 – 2007	First phase of the ETS – the world's largest single carbon market. The environmental outcome was mixed however, because of over-allocation of allowances in some countries and sectors.
2008 – 2012	Second phase of the ETS
March 2007	EU Ministers committed the EU to cutting its emissions by at least 20% of 1990 levels by 2020, and by up to 30% provided other developed countries commit to comparable reductions. They also agreed that renewables should account for 20% of energy consumption by 2020.
January 2008	European Commission put forward a package of proposals, the "Climate action and renewable energy package", also referred to as the climate-energy package, aimed at achieving this 20% reduction target. This contained four elements: 1. A draft law (or 'Directive') to improve and extend the EU ETS; 2. A decision on the effort to be made by member states to reduce their emissions to comply with the commitments of the Community on reduction of such emissions by 2020 ("effort sharing outside the emissions trading system"); 3. A draft law on the promotion of renewables; 4. A draft law on carbon capture and storage.
October 2008	EU leaders met to discuss the Commission's proposals and agreed that a decision on them should be taken by the end of the year.
19 November 2008	The UK Government auctioned allowances in the first auction in Phase II. Four million allowances were sold at a total value of £54.4m, or £13.61 per allowance. The Government plans to auction 25 million allowances in 2009. Approximately 86 million allowances in total will be sold in the UK in Phase II.
12 December 2008	The European Council (EU heads of government) agreed the Commissions proposals but with certain amendments that effectively watered down some provisions.
17 December 2008	The European Parliament passed legislation allowing the changes to enter into force. The text of the legislation can be found at: http://www.europarl.europa.eu/sides/getDoc.do?language=EN&type=TA&reference=20081217&secondRef=TOC