

# **'Trading Up': Improving and extending the European carbon market**

6th Conference of the British-German Environment Forum

*Harnack Haus, Berlin*

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## **Summary**

The sixth British-German Environment Forum was held in Berlin on 26–27 March 2007 with the aim of developing ideas and consensus to move forward the policy debate on solutions to climate change, and in particular the carbon market.

The timing of the meeting was fortunate, following closely the decision by the 2007 Spring European Council to target a 20% cut in greenhouse gas (GHG) production by 2020, compared to 1990 levels. The Council also allowed for a 30% cut if an international agreement is reached. This sets a new challenge for policy instruments in Europe.

The conference heard the serious problem the world faces in limiting the output of GHGs as countries such as China and India rapidly industrialise.

The EU, and in particular the UK and Germany, has led the way in developing mechanisms to reduce carbon dioxide (CO<sub>2</sub>) emissions, and the meeting heard about the successes – and failings – of the EU Emissions Trading Scheme (ETS).

A robust carbon market has been established in a very short time period and the volume of trade is growing month-on-month. But there has been an over-allocation of emission allowances in the first phase (from 2005–07), which has led to a collapse in the carbon price.

While certain industries have taken measures to abate CO<sub>2</sub> emissions, the scheme has not had the effect of reducing EU-wide emissions. Power companies had been able to pass on almost all their carbon costs to consumers, and enjoyed windfall profits. While few argued they were wrong to take advantage of these 'opportunity costs', there was widespread acknowledgement that there should be a fairer system of allocating credits.

However, the first phase was always seen by the European Commission as a 'learning by doing' period, and the real action starts in Phase II (2008–12). For this period, it was

generally agreed that the Commission had done well in tightening the national allocation plans (NAPs) and in making NAP setting a formulaic process – though Germany would have liked more information at an earlier stage.

A major review is under way to decide on the architecture of the ETS post-2012, which will focus on the following areas:

- extending the scope of the directive to other sectors and gases
- more harmonisation and predictability, looking at longer than five-year trading periods, and the possibility of an EU-wide cap
- more robust compliance and enforcement
- linking to other trading schemes – under current rules, the EU ETS can only link to the national schemes of Kyoto Protocol signatories, so it cannot link to the emerging US regional schemes, such as the Regional Greenhouse Gas Initiative (RGGI).

A better dialogue between government, industry, NGOs and other stakeholders will be essential in making the ETS a success. This is something that Germany could learn from the UK, delegates said.

There was a general consensus that auctioning of credits is the fairest way to allocate emissions targets to sectors such as power generation that are not subject to international competition. Politicians and the Commission have recognised this: the UK is already planning to auction 7% of allowances in Phase II, and talks are under way in Germany.

If credits are not to be allocated for free, industry favours a benchmarking approach (setting emissions targets per unit of output, multiplied by best-practice benchmark) for sectors that face competition from overseas – such as cement, steel, aluminium and chemicals. A sectoral agreement could be another suitable mechanism. Many saw using border taxes to deal with competition issues as a 'last resort'.

There was general support for a mixed policy of auctioning and benchmarking, but several delegates emphasised that the competitiveness debate should not be allowed to dominate future talks. While there may be short-term pain, the EU was seen to benefit from being a leader in decarbonising its economy.

Participants agreed a public debate was needed on how auction revenues would be recycled. A number of possible routes are available – returning the money to consumers or to industry; using it to fund transitional technology programmes or mitigation programmes overseas; funding a public body – for example, the UK's Carbon Trust; reducing national debt.

The US trading schemes are planning for significant percentages of auctioning, and the EU would do well to keep an eye on US developments.

The Spring Council's 20/30% target will have an influence on the ETS and other EU policies, but key details have yet to be decided. For instance, what constitutes 'international agreement' for moving to the 30% target. Reaching agreement on burden sharing between countries was seen as a particular problem and little progress has been made so far.

What was clear is that environmental policy must be considered with other policies on energy, the economy, transport, etc. – and that policy instruments other than the ETS are needed beyond 2012. The EU already has targets for biofuel usage, for instance. Carbon capture and storage (CCS) for fossil fuel-burning plants will be another part of future EU policy. However, judging where other decarbonising policies overlap with ETS will be a challenge.

On renewable energy and energy efficiency policies, the UK could learn from Germany, delegates said. The EU must also look at controlling energy demand, as this is where the biggest reductions in GHGs will come between 2010 and 2020.

There was little debate on bringing other sectors into the ETS. The Commission has proposals to include aviation and shipping, and the UK has a desire to include road transport. In the medium term, the Commission said transport will be subject to other policies.

The concept of personal carbon allowances (PCAs) attracted interest and is worth looking at, delegates agreed. The Royal Society for the encouragement of Arts, Manufactures and Commerce (RSA), based in the UK, is looking at the application of PCAs for home energy and petrol purchases, and aviation and public transport.

The concept would help engage the public, and could be an equitable way to deal with carbon emissions. But delegates were wary of the complexity of such a scheme, the risks of double counting and overlap with ETS. The Commission has not thought a great deal about PCAs, and it's not going to be in its EU ETS review. However, the European Parliament would be interested to hear about it.

Policy-makers should be aware that public support for climate change policy is quite high. But there is still a key problem that many people think that personal efforts are a waste of time when China is building a new coal power station every week. People also want to know more about the solutions than the problem, and politicians will have to address these issues if they are to maintain support for their climate policies.

Anglo-German leadership was key in the Spring Council decision, and this should continue to be extended to the international stage. The German G8 presidency will set the stage for the United Nations Framework Convention on Climate Change (UNFCCC) meeting in Bali later in 2007 with the idea of reaching an international decision on a post-Kyoto framework in 2009 – a key year for climate discussions.

Delegates noted that there is still no meaningful offer to developing countries and emerging economies on the table, and the EU should lead this move. It was generally agreed that the EU should do more to engage developing countries in respect of climate agreements. But for the EU to maintain its leadership and credibility, the ETS and other climate policies have to be a success.

Throughout the two-day meeting, delegates engaged in honest and lively discussions on the future of European climate policy. Attempts to limit greenhouse gas emissions clearly affect a broad spectrum of stakeholders, many of whom are resistant to change, so politicians will have to be brave in making policy decisions to safeguard the future of the planet without unduly affecting economic growth and the competitiveness of the EU. The hope is that this meeting will invigorate the leadership shown by Germany and the UK in making such policies.

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***Notes to the editor:***

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