The EU ETS as a corner stone for the global carbon market

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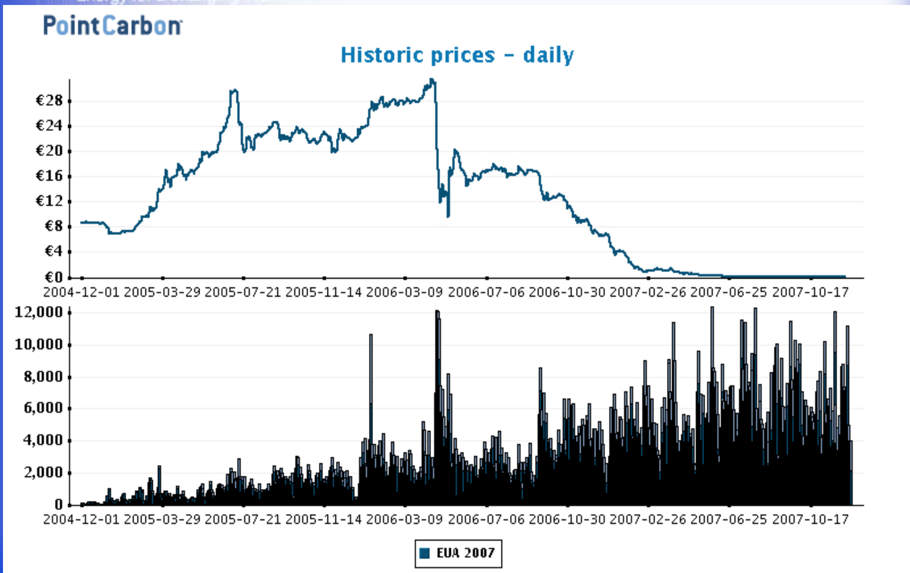
The EU ETS in a nutshell

- Applicable since 1 January 2005, for EU 25
- Permit requirement for CO2
- Mandatory caps on absolute emissions from around 10,000 installations across EU
- Energy intensive sectors covered
- Covers currently around 2 billion tonnes of CO_2 emissions, around half of EU's total CO_2 emissions!
- Linking with other emissions trading systems
- Credits from emission-reducing projects in 178 parties of KP useable

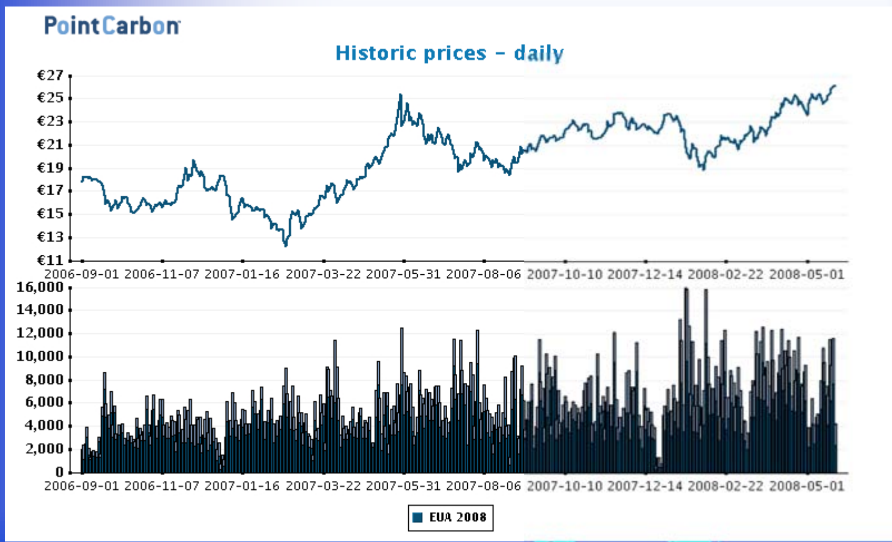
Why emissions trading ?

- Market-based instrument which allows for most cost-effective and targeted environmental policy - no market intervention!
- EU ETS is driver for carbon market: in 2007 valued at around €40 billion (EU ETS: € 28 billion)
- Cornerstone of Europe‘s strategy to implement Kyoto Protocol - major structural element for the post-2012 climate strategy
- EU ETS will contribute to reaching more than 40% of the EU’s 15 Kyoto commitment 2008-2012 (i.e. 3.4% of -8% below 1990)!

Phase 1 prices and trading volumes



Phase 2 prices and trading volumes



The EU Energy and Climate Package

Objectives agreed for 2020

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- 20% GHG reduction compared to 1990
  - Independent commitment
- 30% GHG reduction compared to 1990
  - In context of international agreement
- 20% renewables share of final energy consumption
- 10% biofuels in transport, with
  - production being sustainable
  - second generation biofuels commercially available

What is in the package?

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- Overall Communication
- Revision of EU Emissions Trading System (the ETS)
- Effort sharing in non ETS sectors
- Directive on promotion of renewable energy, report on renewable energy support schemes
- Directive on carbon capture and storage, and Communication on demonstration plants
- Revised environmental state aid guidelines
- Accompanying integrated impact assessment

Where do we stand today?

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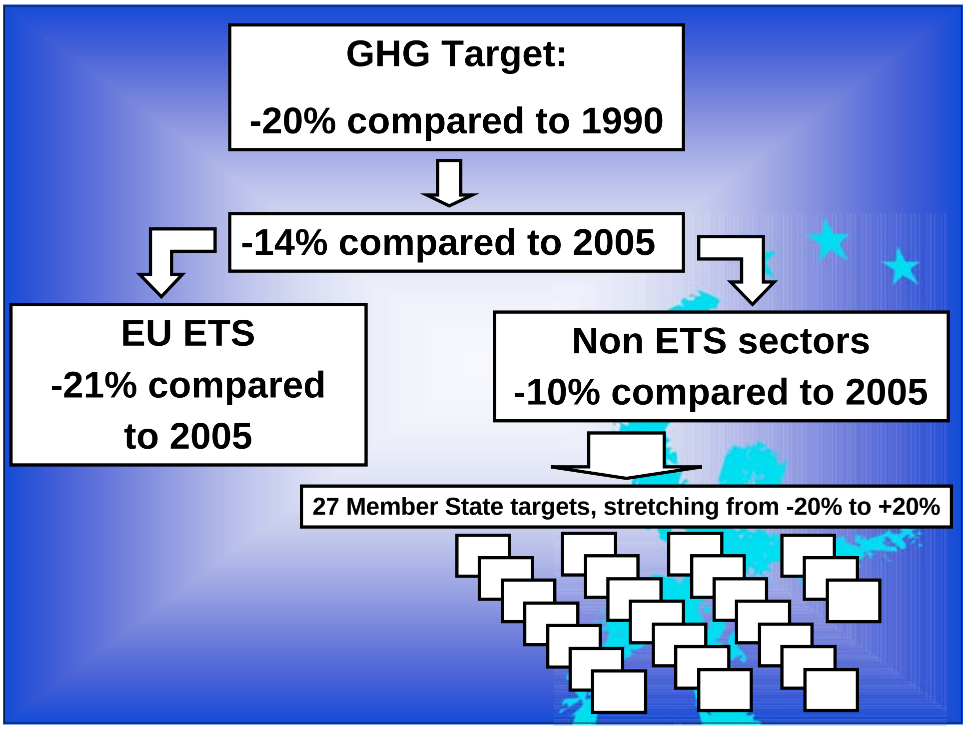
In 2005:

- -6.5% GHG emissions compared to 1990
  - including outbound aviation
- 8.5% renewable energy
  - mainly through large scale hydro and conventional biomass

Targets are ambitious:

- -14% GHG compared to 2005
- +11.5% renewable energy share



Objectives of the review

The post-2012 EU ETS should

- deliver a cost-effective contribution to the independent target or to a stricter target under an international agreement
- be improved based on practical experience
- provide a clear long-term carbon price signal

Outcome stakeholder consultation

- Improve predictability
- Enhance transparency

An EU-wide phase 3 cap

- Setting an EU-wide cap up-front in legislation
  - provides for more certainty and predictability for companies and other market participants
  - separates cap-setting from allocation
  - enables fully harmonised free allocation rules
- Cap in 2020 of 1.72 billion allowances
  - 21 % below 2005 verified emissions
  - Trajectory up to and beyond 2020
  - Tightening in case of international agreement

Allocation principles

- Harmonised allocation rules ensure level playing field across the EU
- Full auctioning for sectors able to pass on costs:
  - Power sector
- Partial free allocation to industry as a transitional measure, to be phased out by 2020
- Exception: higher levels of free allocation where there is significant risk of carbon leakage

More on auctioning

- Auctions are Member State led
  - cross-border / EU-wide auction platform(s) may develop
- Use of auction revenue left to Member States
  - recommendation to use 20 % for environmental/social purposes
- Directive sets core principles for auctioning
  - Non-discrimination, openness, transparency
- Commission Regulation by end 2010 on auctioning fixes details
  - Strongest form of regulation but at the same time less complicated to change than a Directive

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International aspects: JI / CDM

- Companies can already use credits from JI and CDM projects for compliance in phase II (1.4 Gt)
- "Left-over" credits from 2008-2012 can be used 2013-2020 = 1.4 billion tons for 2008-2020 = 1/3 of reduction effort over the period
- With post-2012 agreement:
  - additional use of credits allowed from countries which have ratified the agreement
    - ➢ Important incentive for global climate agreement and reduced cost of additional effort for the EU

State of play
ENVI vote of 7 October

- **Wide support in adopting compromise amendments**
- **Takes into account a range views expressed by industry**
- **Maintains the overall architecture of the EU ETS**
- **Increasing convergence with the views of Member States**
  - **Auctioning is maintained for the power sector, while other sectors will have a transition to full auctioning by 2020 except where there is a significant risk of carbon leakage**
  - **Revenues are to be used to tackle climate change**
  - **Use of high quality CDM, - incentives for DCs**
  - **lower quantitative limit of CERs/ERUs (40% of effort)**

State of play
European Council

- Support for overall architecture
- But there are calls to
  - Share costs in fair manner
  - Recalculate costs due to financial crisis
  - Recognize past efforts (early actions)
- Generally continued political support for first reading agreement

Crunch issues in debate

Carbon leakage

- Which Energy intensive industries get free allocations (quantitative and qualitative criteria, timing, measures, review) and how much for how long?
- Auctioning for electricity and the possibility of derogations
- How deal with indirect effects
- Price volatility

Ambition level

- Switch from 20% to 30% scenario

Crunch issues in debate

Flexibility

- Quantity and quality of JI/CDM
- Use of LULUCF and REDD credits
- How opt-out small installations
- How design the auctions (access, price controls, timing, frequency)

Solidarity

- What base year to use
- Earmarking of revenues from auctioning
- How to distribute revenues from auctions

Next steps

- European Council 15-16 October and Environment Council 20-21 October
- Outcome to complement ENVI vote and orientate discussions in trilogue
- Political compromise by early December
- Formal adoption at a Plenary session of the EP in December

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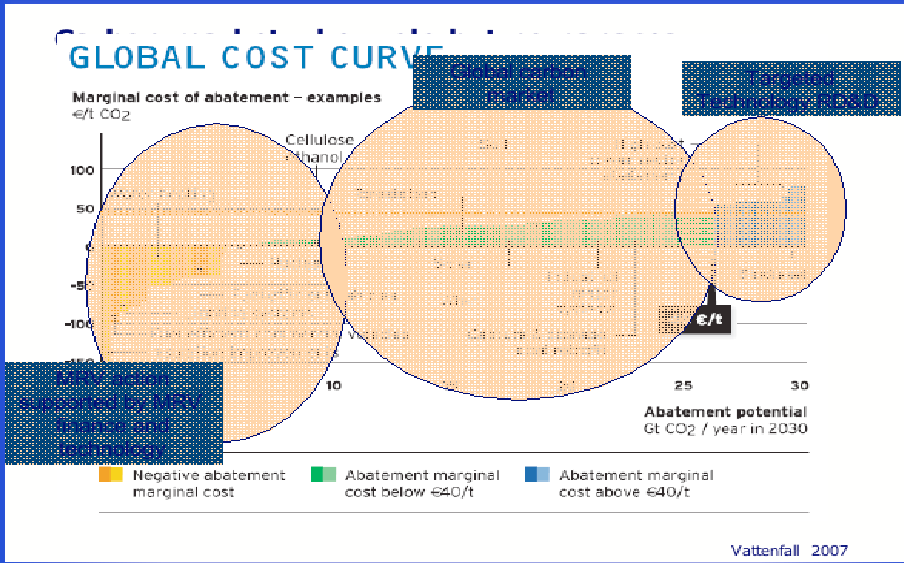
Make the move to the global carbon market a race to the top!

Building a global carbon market

- Significant role of the carbon market already today – should be strengthened post-2012.
- Need to ensure predictability and long term price signal.
- Looking at transatlantic carbon market (EU/US ETS)
- An environmentally more effective **CDM should continue to play a role for LDCs.**
- Offsetting is not enough – carbon market offers promising potential if we succeed in **developing new tools** that build on differentiated contributions by DCs
- Need to set up infrastructure for carbon market related MRV action for DCs
- Carbon market is **part of solution** but not panacea – needs to be combined with other tools to further technology cooperation, financial flows and investment



27 Gt. CO2e emission reduction potential below € 40/ton CO2
10 – 12 Gt. CO2e: carbon market will be the main driver

The CDM – a partial success story

- First international carbon crediting system built with inherent “first mover disadvantage”
- produced different methodologies on the initiative and risk of applicant project participants
- produced expected emission reductions in the order of 1,4 Gt until 2012
- Helps Annex I countries to lower the cost of compliance with the Kyoto Protocol

…However, there are issues with …

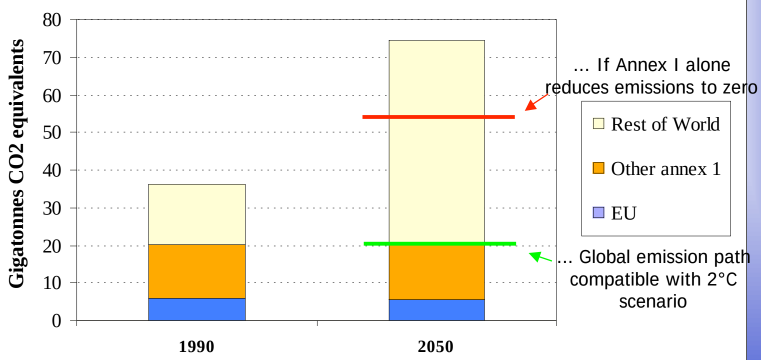
- Additionality
- Problematic project types (HFC-23 and others)
- validation and verification - unclear regime for DOEs, e.g. lack of a verification and validation standard, quality control
- Governance issues of the CDM by the EB

CDM improvements: short run

- Ongoing efforts to improve efficiency and expand coverage of the CDM
  - streamlined procedures, programmatic
- Governance arrangements need improvement:
  - professional institutional and process support
  - more transparent and due decision making process
  - improving the DOE accreditation procedure
  - clear guidelines by the EB for validation and verification of DOEs

"Offsetting" alone cannot solve climate change problem

Figure 1: Projected development of greenhouse gas emissions in different regions of the world



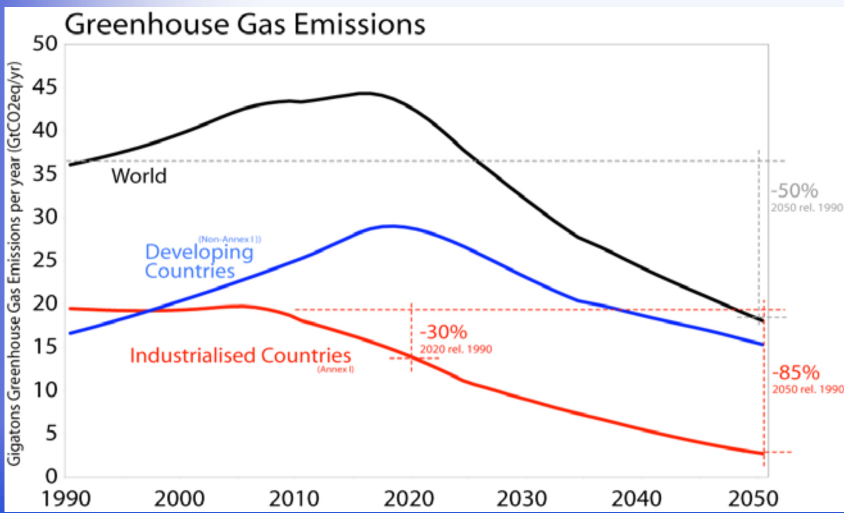
Source: Greenhouse gas reduction pathways in the UNFCCC process up to 2025, CNRS/LEPII-EPE, RIVM/MNP, ICCS-NTUA, CES-KUL (2003).

CDM improvements: longer term

- Complement Annex I commitments with **substantial deviations from baseline emissions** in advanced developing regions
- Offsetting can only continue for **some (LDC)**
- Evolution of CDM for enhanced participation of developing countries **moving beyond the project-based offsetting approach of the CDM**
  - This could include **sector-based approaches** such as **no-lose targets** or **binding sectoral targets** but should ultimately lead to the recognition of emissions trading instruments
  - Need to ensure **adequate monitoring and reporting of emissions in developing countries,** in particular in the BRICS countries

From Poznan to Copenhagen in 2009

ICs 80-95% below 1990 by 2050
DCs 15-30% below BAU by 2020



Mitigation by developed countries

- Quantified reduction targets are the backbone of efforts, including for the US
- Possibly additional efforts, such as finance for REDD and RD&D, but the latter not necessarily under the UNFCCC
- Use of carbon market should be supplemental to domestic action
- EU position on differentiation should reflect:
  - "past efforts", but also balance "hot air" (~5% of AI emissions p.a. if spread over a 10 year period)
  - "cost of future efforts" – GHG/GDP as an indicator?
  - "capability to act" – GDP/capita should have a bearing on reductions
- For "new developed countries" some freezing of emissions after 2012 could be proposed and thereafter, e.g., return to 2005 levels by 2020 (Mex, Korea, Belarus, Turkey, Croatia)

Mitigation by developing countries

- Need three layers of discussion:
  - i) what should be done by all countries? E.g. no regret policies (Energy efficiency etc.)
  - ii) what enhanced effort is needed from advanced DCs, as defined and differentiated by criteria, such as GDP/capita and share of global emissions (could be set out in national low carbon development plans).
  - iii) implications for carbon leakage (treatment of exposed industries)
- Maintain that LDCs would not be subject to any new commitments

Road to Copenhagen

- EU committed to maintain leading role
- High and increasing public expectations
- US role and position is key – new US govt 2009
- Will internal US legislation determine process?
- Since Accra: “meat on table now”.
- Poznan milestone for Copenhagen?
  - Shift into full negotiating mode!
  - Shared vision and AI targets: to confirm nature of industrialised countries’ targets? Initiate discussion around differentiation AIC
  - NAI: enhanced contributions from emerging economies?
  - Finance: to indicate types of funding solutions – Copenhagen to fill in numbers…
  - “early harvest” on post-2012 KP reform issues?
- Hard to imagine a weak outcome in Copenhagen 2009 but also difficult to see all details agreed already there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