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Recommendations for the EU trading directive from an economic viewpoint

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Structure of presentation

- The international climate regime after Marrakech
- EU climate policy challenges
- Evaluation of the draft directive from an economist´s viewpoint
- Outlook

The general framework of the international climate regime

- Targets weakened considerably by new sinks, probably by about 3 percentage points
- Supply of hot air likely to be higher than demand, if U.S. stays out
- Project based mechanisms are squeezed out under a competitive market
- If hot air sellers reduce supply to maximise revenues, project-based mechanisms can play a role, but are always at the mercy of hot air sellers

The general framework of the international climate regime II

- Full fungibility and banking, thresholds can be circumvented
- Institutional framework rather strict
- Reporting becomes crucial to be eligible for the mechanisms
- Compliance penalty acts as deterrent

Prices will be much lower than anticipated

The global GHG market

Necessary emissions reduction compared to BAU (without USA)	1000 Mt CO_2
"Hot Air" (Cartel?)	up to 1100 Mt CO_2 400 Mt CO_2
JI and Emissions Trading	100 Mt CO_2
CDM	350 Mt CO_2,
Price per t CO_2	1 ? Grey market: 1-3 €

If all Hot Air was put on the market, the price would be ZERO!

EU climate policy challenges

- Good luck from German reunification and UK coal to gas conversion comes to an end
- Transport emissions rising everywhere
- Steeply rising emission trends in cohesion countries
- Nuclear phase out in Germany is a challenge for the second commitment period
- Lack of joint policy instruments leads to strongly differing stringency of national climate policies
- Government changes jeopardise future progress (Denmark, Italy)

The EU draft directive from an economists´ viewpoint I

- Broad coverage of emissions 😐
  - Mandatory participation avoids free riding ☺
  - Only large installations, exclusion of chemical and non-ferrous metal sector (46% covered), CO_2 only ☹
  - *a hybrid downstream (industry) and upstream (transport + households) system would have been preferable*
  - *closed installations should not get further allocations of permits*
- Strong verification rules ☺
  - Clear verification procedure
- Strong sanctions ☺
  - High level penalty

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The EU draft directive from an economists´ viewpoint II

- Avoidance of competitive distortions 😐
  - absolute emissions targets are a good base as they do not give an incentive for production growth ☺
  - harmonisation of allocation rules which however remain unclear and even contradictory 😐
  - definition of base year, early action and treatment of new entrants lacks ☹
  - grandfathering at least until 2008 ☹
  - *a better solution would have been compulsory auctioning - at least for a part of permits (hybrid) to get an early price signal*
  - *define base year late enough to have good data but before start of discussion on emissions trading - 2000 appropriate*

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The EU draft directive from an economists´ viewpoint III

- Early and long-term incentives ☺
  - Start in 2005 allows learning for commitment period
- Integration in the international market ☹
  - no acceptance of CDM and JI credits (possibly later), leading to a price differential
  - *CDM credits should be accepted from the beginning*
  - *If there are fears of importing low-quality permits, one can demand extra safeguards for project additionality and baseline calculation*

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Outlook

- With the draft trading directive, the EU is a pioneer in developing creative climate policy instruments
- Avoid the standoff that characterised the debate on the CO_2/energy tax
- Retain the mandatory character of the scheme despite industry opposition; otherwise demand coverage of non-participants by equivalent instruments (emissions tax or upstream system, not voluntary agreement). Avoid a subsidy-based regime (bad example: UK)

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Outlook II

- If auctioning is impossible, benchmarking avoids subsidisation of high emitters and also takes early action into account
- Aim for close integration into the international regime via utilisation of the Kyoto Mechanisms; this alleviates fears of a high-price regime
- Try to integrate the other gases for specific large-scale processes (nitric acid, aluminium production)
- Trading can help to avoid an unravelling of EU climate policy due to new challenges

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Thank you!

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