



**ET- The start of a new phase of climate policy
The view of a German NGO
Nine Thoughts**

By

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ET- The start of a new phase of climate policy

1. ET- a new climate policy design

Emission Trading comes - and the EU is front runner. This means a fundamental change of climate policy design in Europe. Who would have thought so some years ago, when the US pushed for this instrument and the EU was very skeptical? The instrument fits with the absolute targets of the Kyoto Protocol and with the Kyoto mechanisms. Rightly designed it fits with a least cost strategy and with the absolute reduction strategy. The combination of rigidity (monitoring, sanctions) and flexibility provides a good basis for a necessary safe landing approach. The time for ET is ripe. The environmental targets can be met, but industry can choose a strategy that fits with their investment cycle.

2. The design of the system must guarantee its integrity

It belongs to the merits of an ET system, that it involves new actors in the climate game: actors, which do not want to save the climate, but want to earn money. This is necessary as the limited number of well meaning actors alone will not reach the necessary reductions in the EU and worldwide. But it also means that the design of the ET-system must guarantee the integrity of the system. The system shall create business opportunities – but only as long as the environmental integrity is saved.

3. ET has the potential to become an important risk management instrument

If Kyoto comes into force, the regulative risk for businesses with high carbon risks, will be further increased. Next to investments in renewable energy and energy efficiency, the participation in an ET system is the most elegant way to manage this regulative risk. More and more carbon intense businesses worldwide see ET first of all as an risk management instrument. They buy options to manage certain risks.

4. More certainty regarding the standards for national allocation plans is needed

As a German NGO it is interesting for us to analyze, why about one third of the affected German industry is strictly opposed to the EU-ET-directive. It is not only the comfortable nest of a voluntary agreement with relative targets, branch related targets, and no business related sanctions. It is not only that within a branch related voluntary agreement the free riders are the winner, while in an ET system the climate savers are the winners. One other important reason is the lack of clarity regarding the national allocation plan in the directive and it's annex 3. There is a concern that the many climate relevant investments of German industry between 1990 and 2000 will not be taken into account as early action. (It cannot be expected that German businesses get credit for the wall fall profits that appeared without investments. But it is understandable that they do not want to penalized for climate related investments.). And there is a concern, that in the absence of coordinated European criteria for the national allocation plans, other industries could become privileged. Finally there is a concern, that Germany would implement the same criteria more stringent than other countries. So at the moment most of the affected industry can present worst case scenarios with negative results of an introduction of the EU directive. More clarity regarding the allocation criteria would mean that only those businesses, which really will be among the losers, would continue with strong opposition.

5. Between liquidity and loopholes

Liquidity in the market reduces the risk of market participants, increases the probability of price jumps and reduces the market power of individuals. So liquidity should generally be increased. This can be done by choosing a larger geographic area for emission trading, a greater number of participants, by including more branches, sectors, gases, or actors with very different compliance costs.

But liquidity should only be increased as long as it doesn't harm the environmental integrity. And as ET is a very new instrument within the EU, its role should start on the safe side and should be increased over time. Already now the EU-Commission has proposed the biggest Emission Trading market of the world. This is the right setting for the beginning.

- ◆ If project based mechanisms (CDM, JI) should be included over time, only “golden standard certificates” should be allowed into the European registry. An additional “golden standard” will be necessary, as the regulations of Bonn and Marrakech alone do not secure the environmental integrity. Of course there are ways to go round a golden standard. But even in this case two different prices for golden standard projects and others would appear. And from a business perspective high quality products would be more adequate within a risk management strategy.
- ◆ Other gases should only be included, as soon as they can be calculated and monitored with very little uncertainty. As the greenhouse potential per molecule for those other Kyoto gases is much higher (in some cases some thousand times) than that of a CO₂ molecule, much more precision is necessary. To minimise at the same time the bureaucratic load an safety discount would be one option.
- ◆ The trading with non EU-states should only be allowed, if bilateral contracts safeguard the environmental integrity an prevent competitive distortion.

It should be part of the further development of an EU-ET-system, to integrate these options as long as they don't integrate loopholes into the system. Big loopholes could undermine the economical and ecological integrity of the system. Nobody should be allowed to print money without reducing the equivalent amount of greenhouse gases.

6. The need of an obligatory ET-program

It is very interesting, that even the „No-sayer“ within German industry argue:
 „A phase with trading of emission certificates, where business only voluntarily can participate, can not bring any valid information. The participating businesses would not represent an average over all affected installations“ (Ströbele et al, 2002, p. 10). As those authors would expect to low prices in a voluntary system, many others would expect to high prices – because of the reduced liquidity – in a voluntary system. The incorrect market signal is in any case a strong argument not to start with a voluntary system. It is more than doubtful, whether a market with voluntary business or country participation could generate enough liquidity, so that the EU can reach its target with a reasonable price.

So it was a wise decision of the EU Commission to start already in the pilot phase (2005-2007) with a mandatory ET-system.

7. Least cost strategy allows stricter targets

The Emission Trading directive is an important element of a least cost strategy to reach the EU-climate targets.

This makes sense. A least cost approach, which proves how cheap (quite often even cost effective) climate protection can be, is the most convincing argument for the US and for developing countries to join the system over time. Only a least cost approach will create the political momentum, which allow for the second commitment period the necessary reduction targets. If the EU and Japan will create an international ET-market, international businesses in the US will create more and more pressure, that they want to participate in this programme. A well working ET system might be the single most important attraction for the US to come back on board of international climate policy.

8. To introduce renewable energy into the market needs additional instruments

There are at least three reasons, why an additional and ambitious policy is necessary to introduce renewable energy into the market.

One: the external costs of energy are so far not internalised. There is still a huge amount of subsidies for coal and nuclear around. Renewable energy needs support to overcome this problem.

Two: ET does only support least cost options. It doesn't do enough to reduce the price of renewable energy, so that those can be the least cost options for tomorrow.

Three: Renewable energy has much more benefits to offer than just CO₂-reduction.

9. The directive might negatively affect the competitiveness of co-generation

In the proposal in all relevant installations all fuel must be taken into account. This might be a major problem for the competitiveness of co-generation. The additional costs can – because of

the competition – not transferred on the heat market (as far as the heat market is not part of the system). This could make many co-generation installations non-competitive. This cannot be the target of a climate protection directive.

One possibility would be, that fuels, which are used for district heating would be freed from the obligation to hold certificates. Technically this should be no problem. An other option would be a cost free grandfathering for this fuel use. In this case, an additional incentive to optimise the district heat process would be generated.

Conclusions

The time has come for an EU-ET-system. This strong instrument creates a lot of opportunities for climate and business, but it also creates new market and climate risks. The EU should move forward and keep the balance between the need for environmental integrity, the need for liquidity and the need to introduce this new instrument step by step.

As the ET-system is a central instrument to reach *the necessary climate targets*, it never can be room for loopholes, which undermine the environmental integrity.