Opinion of the European Economic and Social Committee on the 'Proposal for a directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community'

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On 13 February 2008 the Council of the European Union decided to consult the European Economic and Social Committee, under Article 175 of the Treaty establishing the European Community, on the

Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading system of the Community.

The Section for Agriculture, Rural Development and the Environment, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 4 June 2008. The rapporteur was Mr Adams.

At its 446th plenary session, held on 9 and 10 July 2008 (meeting of 9 July), the European Economic and Social Committee adopted the following opinion by 124 votes to 2 with 8 abstentions.

1. **Conclusions and Recommendations**

1.1 The value of the Emission Trading System (ETS) will be measured by its impact on European GHG emissions and its relevance and example in stimulating global action and/or evolving into a comprehensive global scheme. In this context:

— The move towards more auctioning of allowances is welcome as it is in line with the polluter-pays-principle, avoids windfall profits, incentivises and funds low carbon installations and products and fosters innovation.

— Measures in order to protect specific energy-intensive sectors and sub-sectors vulnerable to international competition should be considered in the absence of an effective international agreement on climate change which places emission reduction obligations on all respective industries globally in order to avoid 'carbon leakage'. The EU ETS must not have a negative impact on the competitiveness of EU industry.

— Regulation on auctioning should be prepared and adopted as soon as possible to avoid unnecessary uncertainties.

— Proposals should be advanced by the Commission as to how the commitment to move from a 20 % to a 30 % reduction target will be achieved in the event of an international agreement.

— Every effort should be made to influence and form a common platform with emerging 'cap and trade' legislation in the USA and other OECD countries.

— Maritime transport should be included in the ETS if effective proposals are not urgently presented by the International Maritime Organisation.

1.2 The ETS must be seen to stimulate a low-carbon economy and encourage climate protection, adaptation and mitigation.

— If free allowances are provided, this should be done in the context of rigorous benchmarking and performance-based targets.

— At least 50 % of revenues from allowance auctioning should be mandated to support the measures defined in Article 10.3.a-f.

— Potential disincentives which may limit the contribution and growth of co-generation (CHP — combined heat and power) and efficient district heating schemes should be eliminated.

— The action on issues of forestry as a carbon sink, deforestation and land use must have greater emphasis than currently allowed for in the Commissions package.

1.3 The ETS should seek to minimise bureaucratic obstacles and achieve clarity and transparency.

— Those measures in the proposal whose development is currently left to the comitology process need urgent attention and clarification.

— The Commission should consider raising — from 10 000 to 25 000 tonnes — the exclusion limit for small installations, provided equivalent, compensatory measures are in place.

1.4 The ETS should be seen as equitable within the EU whilst recognising the pressing need of newly industrialising and less developed countries to create sustainable growth and poverty alleviation.

— A rebalancing of the burden between the sectors covered by ETS and those outside of it is to be considered.

— The implications of restricting the use of Joint Implementation (JI)/Clean Development Mechanism (CDM) credits in the absence of an international agreement should be reviewed.

— A solution must be found to potential difficulties which may be caused in those Eastern European Member States whose main grid electricity supply comes from Russia rather than the EU.

2. **Introduction**

2.1 The ETS was established by Directive 2003/87/EC in October 2003. It aims to control contributing factors to climate change, specifically anthropogenic greenhouse gases (GHGs), by providing economic incentives for lowering emissions. It is a 'cap and trade' system where a limit or *cap* has been set on the amount of a pollutant (mainly CO_2) that can be emitted. The ETS is the EU's most significant mechanism for limiting GHGs, preferred over direct taxation on carbon or direct regulation.

3. **General Principles**

3.1 The current ETS applies to over 10 000 installations in the energy and industrial sectors, together responsible for 40 % of the EU's GHGs. Installations are issued emission permits *ex ante* and are required to surrender a number of *allowances* (or credits) which represent the right to emit a specific amount equivalent to their actual emissions. The total amount of allowances and credits cannot exceed the cap, limiting total emissions to that level. Companies that emit more GHGs than the number of allowances they received must buy credits from those who pollute less or at the auctions of any further allowances.

3.2 The transfer of allowances is referred to as a *trade*. In effect, any emitter under the system is paying a charge for polluting, while any installation will be rewarded for having reduced emissions by more than was needed. Thus, in theory, those that can easily reduce emissions most cheaply will do so, achieving the pollution reduction at the lowest possible cost to society. In the ETS an 'allowance' equates to the right to emit one tonne of carbon dioxide equivalent for a specified period — other GHGs being converted into CO_2 equivalents.

3.3 Member States may also allow the use of credits from emission-saving projects in third countries in the same way as allowances. Such projects have to be recognised under Kyoto's Joint Implementation (JI) mechanism or Clean Development Mechanism (CDM).

4. **ETS trading periods**

4.1 *ETS first trading period 1.1.2005-31.12.2007*

4.1.1 The first learning phase established the infrastructure of emissions trading but was severely limited in effectiveness by over-allocation of allowances by Member States (For the first and second phase Member States have drawn up national allocation plans — NAPs — giving a total level of emissions and how many allowances each installation receives.). There was a wide variation in the allowance trading price during this period, including a collapse of the carbon price by the end of the first trading period.

4.1.2 Numerous criticisms of the ETS emerged which focused on initial allocation methods and the use of proceeds; the level of the cap; problems of equity, complexity, monitoring and enforcement; the risk of encouraging relocation to unregulated countries by major emitting industries; the value, credibility and reliability of JI/CDM credits and the future imposition of disadvantageous production costs. It became clear that these issues would have to be dealt with in revisions to the ETS for the system to gain credibility with both industry and NGOs.

4.2 *ETS second trading period 1.1.2008-31.12.2012*

4.2.1 This phase applies to all 27 MS and coincides with the first commitment period of the Kyoto Protocol and the requirement to reduce GHGs. So far the allowance trading price has been on a stable upward trend at levels that strongly encourage reduction measures. The current (May 2008) trading price is around EUR 25 per tonne. For this period the Commission has carried out a systematic assessment of the caps proposed by Member States based on verified emissions and as a result emissions from ETS sectors have been capped at an average of 6.5 % below 2005 levels. There has been little other scope for system change or modification in the second trading period though emitters actively continue to respond and adjust. Data verification and trading experience continues to accumulate, which, for the most part, confirms the schemes underlying concept.

4.3 *ETS third trading period 2013-2020*

4.3.1 The Commission is now proposing significant changes to the ETS which will take effect during this phase. This is the purpose of amending Directive 2003/87/EC.

5. **Summary of the proposed amending Directive**

5.1 Although the EU ETS has created the world's largest single carbon market ([1]), the initial excessive allocation of (free) allowances in NAPs was a setback and clearly not in line with efficient reduction of emissions in the ETS sectors, EU-wide. In the context of firm GHG reduction commitments the revised ETS is seen as essential in providing a long-term carbon price signal, enabling incentives for low-carbon investments and transforming Europe into a low GHG economy.

5.2 The amendments will:

— introduce one EU-wide cap on emission allowances instead of 27 national caps — NAPs will cease to exist;

— greatly increase the proportion of allowances which are auctioned and harmonise rules on free allocation to promote carbon-efficient technologies;

— establish part of the rights to auction as based on per capita income;

— streamline key definitions and improve legal and technical clarity;

— include new sectors (petrochemicals, ammonia and aluminium) and new GHGs (nitrous oxide and perfluorocarbons) increasing coverage by 6 %;

— enable smaller installations to be excluded from the ETS, subject to compensating measures;

— set out rules for the use of credits stemming from JI/CDM projects.

5.3 Starting in 2013, allowances will decrease annually ([2]) leading to a 21 % reduction of GHGs in the EU ETS sector by 2020, compared with 2005. This reduction process will be continued into the fourth phase (2021-2028) at the same rate. Concurrently, the proportion of allowances being auctioned will be increased, starting at 60 % in 2013. It is proposed that the power generation sector should not receive any free allocation and would thus be required to purchase all allowances at auction or at the secondary market from 2013, with a general phasing out of free allowances in other sectors by 2020. The exceptions will be sectors judged to be at significant risk of 'carbon leakage' — relocation to countries without comparable emission constraints and therefore increasing emissions globally. Such sectors may have a free allowance of up to 100 %. This decision will be taken in 2011. Member States will carry out the auctions and be encouraged, though not required, to use income to invest in climate friendly policies.

5.4 Certainty is given that JI/CDM credits (from third countries) which can now be purchased by EU operators can be used in the period until 2020. The total number to be used in this period is equal to the total quantity that has been allowed for use in the 2nd trading period, i.e. 1.4 billion allowances, which corresponds to one third of the overall reduction effort. When the EU steps up its reduction effort in the context of an international climate pact, 50 % of the additional effort can be achieved by JI/CDM credits.

5.5 Although credits from land use (carbon 'sinks' like forests) will not be allowed, domestic credits from emission saving schemes not covered by the ETS could be allowed, provided straightforward rules can be devised.

5.6 Provision has been made for the EU ETS to link with other trading systems to encourage the development of a worldwide system.

5.7 Contingent on the conclusion of an international agreement, the amount of allowances under the ETS will be reduced in line with this agreement, while the scope for recurring to CDMs will be increased.

5.8 A 5 % provision of allocations for new installations that enter the system after 2013 will be made. It is probable that aircraft emissions will become part of the ETS towards the end of the second period but this is covered by a separate proposal ([3]).

5.9 There are no provisions for including maritime transport into the ETS.

6. **General Comments**

6.1 The EU ETS is not an academic exercise nor a type of 'green' taxation. It combines elements of a free market approach with regulation and general direction mediated and adjusted through a political process. Individual companies are free to choose how or if they will reduce their emissions and should select the least-cost way to comply with the pollution regulation. The ETS's main role is therefore to create incentives which reduce the cost of achieving a pollution reduction goal. The EESC endorses and supports this approach.

([1]) The World Bank, State and Trends of the Carbon Market, May 2007.
([2]) From 1.974 million tonnes of CO_2 to 1.720 million tonnes.
([3]) EESC opinion: OJ C 175 of 27.7.2007, p. 47.

6.2 The existing pollution reduction goal — to stabilise GHGs in the atmosphere at 450-550 ppm by 2050 — is estimated to cost around 1 % of global GDP. Failure to act effectively could reduce global GDP by 20 % [4]. However, the continuing flow of evidence and research [5] indicates accelerating GHG production, a reduction in the planet's absorption capacity and seriously questions whether reduction targets are adequate.

6.3 The ETS is effectively aiming at definitive leadership in what must become a global effort. This process is taking place in a global setting as the atmosphere is part of the global commons. Therefore evaluation of the system cannot exclude its interaction and impact on global polluters.

6.4 It should be noted that outline legislation in the US, likely to come into effect in the new administration, is based on a cap-and trade system with similar features. The possibility of a joint US/EU programme would be a highly significant step towards a global scheme, as would links with other proposed schemes in OECD countries.

6.5 The EESC has therefore paid particular attention to the role of the ETS in delivering equitable and sustainable impact on global GHG reduction. Does it demonstrate that European action is both credible and effective? In this context it has to be stated that the EU target of a 20 % reduction in GHG emissions by 2020 compared to 1990 levels (which underlies the ETS and the burden sharing proposals) is lower than the 25-40 % reduction range for industrialised nations which was supported by the EU at the Bali Climate Change Conference in December 2007. The Commission starts from the targets as agreed in the European Spring Council 2007 leaving undiscussed whether this level of reduction is really sufficient to achieve global objectives or whether it is just the maximum reduction that may conceivably be accepted, given the balance of short-term political and economically motivated interests of Member States. The EESC concludes that accumulating evidence on climate change demands the re-setting of targets to achieve greater GHG emission reductions.

6.6 The EESC supports the move towards more auctioning of allowances. Auctioning is in line with the polluter-pays-principle, avoids windfall profits, gives incentives and generates funds to invest in low carbon installations and products and thus fosters innovation.

6.7 There are, at present, many unresolved issues which concern European business in general. These centre around a revised ETS imposing competitive disadvantages on industry, particularly with respect to newly industrialising countries outside the EU. Such countries argue, with some justification, that two centuries of Western industrialisation and contributory GHG emissions must be taken into account, as must their drive to lift substantial sectors of their population out of poverty. A global agreement resolving such issues will need to be confident that it has greater support and understanding of these factors by consumers and industry in OECD countries.

7. **Specific Comments**

7.1 If the EU ETS is to become the global standard for carbon trading then it is essential that the scheme is as robust and effective as possible. The EESC therefore recommends:

7.1.1 The free allocation of allowances to specific large energy-intensive sectors and sub-sectors vulnerable to international competition should only be considered in the absence of an effective international agreement on climate change which places emission reduction obligations on all respective industries globally. The EU ETS must not have a negative impact on the competitiveness of EU industry.

7.1.2 If possible, an earlier decision should be made as regards the sectors which will, due to the risk of carbon leakage, receive free allowances. These sectors will be identified by June 2010 but a decision should be made earlier, in connection with the directives, so as to avoid uncertainty in the investment climate and so that the sectors concerned can make necessary long-term plans.

7.1.3 Although auctioning is to be the major allowance allocation method, there is almost no indication of how such auctioning would be organised. Reference to introduce a regulation on auctioning only by 31 December 2010 brings additional uncertainty for all of the EU ETS participants in view of the necessary pending massive investments in the energy sector.

7.1.4 A rebalancing of the burden between the sectors covered by ETS and those outside of it is to be considered. The EESC questions if the distribution of the reduction obligations between sectors covered by ETS (– 21 % compared to 2005 levels) and the others (– 10 % compared to 2005 levels) is justified. Research [6] shows that in some sectors which are not covered by ETS, especially in the two biggest ones, buildings and transport, there is a potential to reduce emissions at zero or even at negative costs. These are moreover sectors where the risk of carbon leakage is relatively small or nonexistent. The buildings sector in addition has a large potential for job creation within the EU.

[4] The Stern Review 2006.

[5] According to the Mauna Loa observatory in Hawaii, CO_2 levels in the atmosphere are already at 387 ppm, the highest for at least the last 650 000 years.

[6] Vattenfall/McKinsey, The Climate Map http://www.vattenfall.com/www/ccc/ccc/Gemeinsame_Inhalte/DOCUMENT/567263vattenfall/P0271636.pdf.

7.1.5 All allowances allocated to air transport when it joins the scheme are to be auctioned ([7]).

7.1.6 In view of the growing GHGs emissions from shipping (1.12 billion tonnes globally — twice as much as emissions from aviation ([8])) the Commission should bring forward measures to include shipping in the ETS if effective proposals are not urgently presented by the International Maritime Organisation.

7.1.7 The revenue generated through the auctioning of allowances, currently estimated at EUR 50 billion per annum by 2020, should be, to a much greater degree, mandated to fund climate protection, mitigation and adaptation measures — with a specific focus on vulnerable, less-developed countries and towards research and development. In the proposal (Article 10 paragraph 3) suggesting a 20 % allocation is insufficient and misses an opportunity to greatly stimulate the move to a low-carbon economy. The EESC recommends this is increased to at least 50 % of revenues. Attention should be paid to supporting the role of forestry, reafforestation and the prevention of deforestation in the EU and elsewhere where this is demonstrated to provide an effective carbon sink.

7.1.8 Greater clarity and transparency should be apparent in those measures in the proposal whose development is currently left to the comitology procedure.

7.1.9 The Commission should consider raising — from 10 000 to 25 000 tonnes — the exclusion limit for small installations, provided equivalent, compensatory measures are in place.

7.1.10 A clearer indication should be given in the proposal of how, once an international agreement has been reached, the EU will fulfil its commitment to make a further increase in CO_2 reduction from 20 % to 30 %.

7.1.11 To prevent an adverse effect on the growth and contribution of co-generation (CHP) schemes MS are urged to review their 'feed-in' tariffs.

7.1.12 Regarding district heating, measures should be taken to avoid disincentivising efficient examples of such programmes.

7.1.13 A solution must be found to potential difficulties which may be caused in those Eastern European Member States whose main grid electricity supply comes from Russia rather than the EU.

7.1.14 The current proposal to limit the possibility to use JI/CDM credits pending an international agreement should be kept under review, particularly in the light of the adverse effects on the developing international capital funding market for such programmes.

Brussels, 9 July 2008.

The President
of the European Economic and Social Committee
Dimitris DIMITRIADIS

([7]) Consistent with the Committee's previous recommendation, OJ C 175, 27.7.2007, p. 47.
([8]) IMO report February 2008.