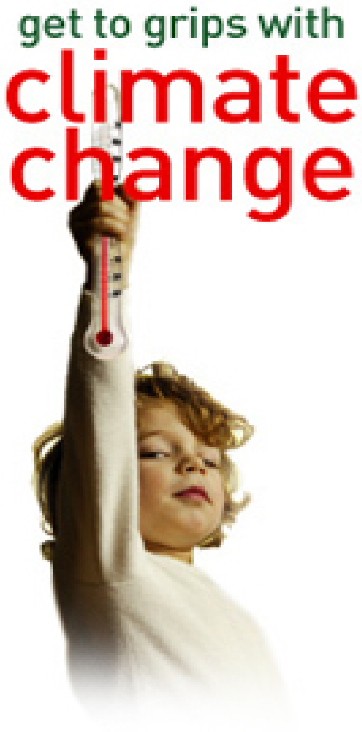

The EU emissions trading scheme as *the* driver for the global carbon market

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European Commission

The EU ETS as the Pillar of the Carbon Market

- Applicable since 1 January 2005, for 25 EU countries (extended to 27 countries in January 2007)
- Mandatory cap on absolute emissions across more than 10,000 large energy-intensive installations across the continent
- Covers around 2 billion tonnes of CO_2 emissions, half of EU's total emissions
- Simple and cost-effective approach to reducing emissions, with single market for trading allowances
- Linking foreseen with other emissions trading schemes
- Credits from emission-reducing projects in 168 countries useable by companies for meeting objective

Stages of development of EU ETS

- Phase 1 from 2005 to 2007
- Phase 2 from 2008 to 2012 - overlapping with first commitment period of the Kyoto Protocol
- Phase 3 from 2013 to 20xx
  – Length decided in legislative review

A balance towards the end of the start-up period

Establishment of IT infrastructure underpinning the market.

Companies start monitoring and reporting emissions.

Availability of robust and verified emissions data.

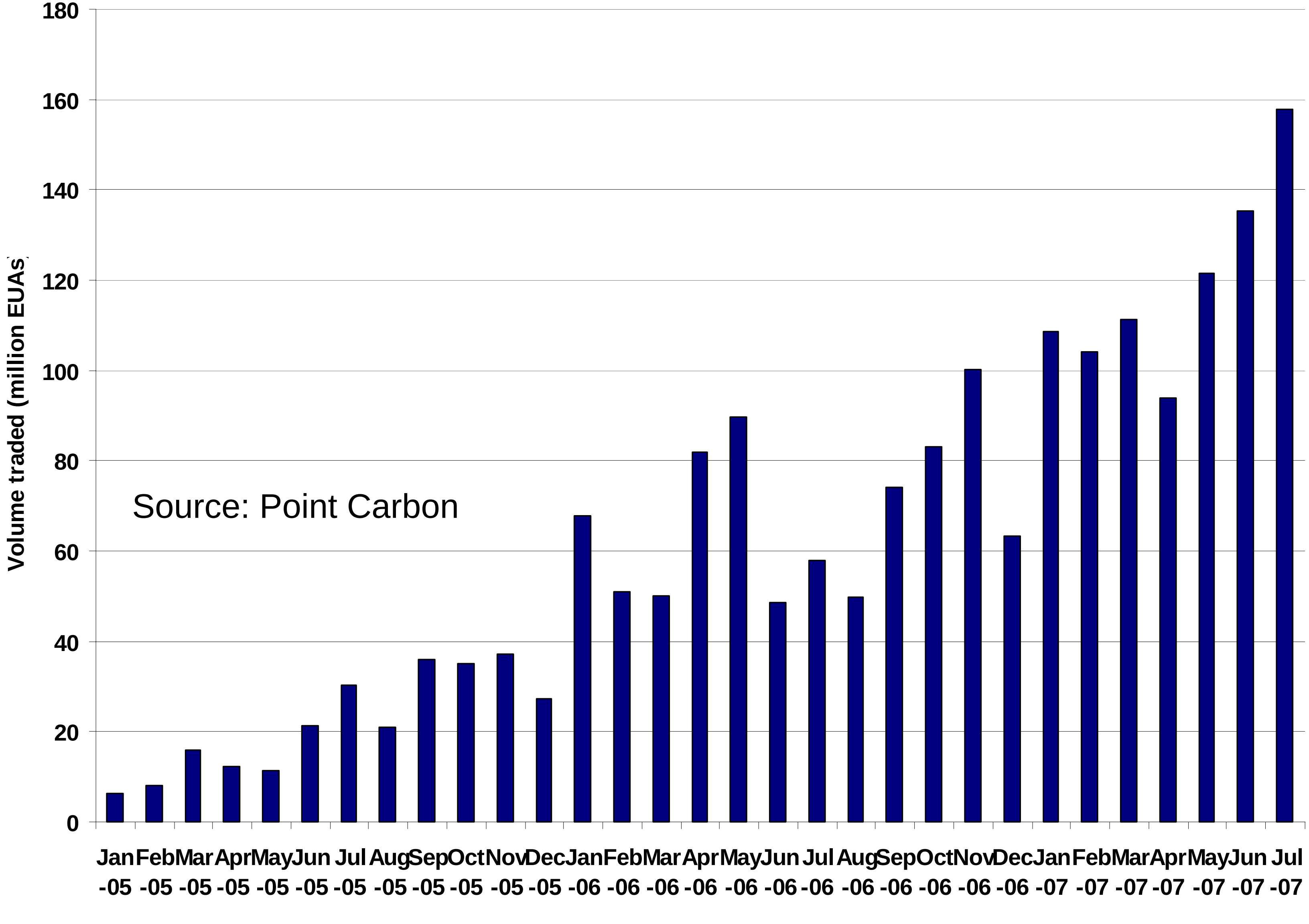
Valuable learning for companies and regulators alike.

Increasingly liquid secondary market has emerged.

Lots of interest triggered outside Europe.

Limited immediate environmental benefits.

Volume of allowances traded



EU ETS Price Development

To what extent will the second trading period be different?

There will be fewer allowances in the market.

We will capitalise on the valuable experience from the first trading period.

There will be more auctioning.

The market will increasingly mature.

Governments will do much better in handling market-sensitive data.

The first trading schemes paralleling the EU ETS will emerge (e.g. RGGI in 2009)

The emerging shape of the second phase and EU-wide cap

- First period annual average allocation (incl. reserves and auctioning) for approved phase 2 NAPs amounts to 2142 Mt
- Verified emissions in 2005 for approved phase 2 NAPs amount to **1974 Mt**
- Proposed second period annual average allocation (incl. reserves and auctioning) for approved phase 2 NAPs amounted to 2126 Mt
- Allowed second period annual average allocation (incl. reserves and auctioning) for approved phase 2 NAPs amounts to **1928 Mt**
- Net shortage in relation 2005 verified emissions amounts to **~130 Mt or 6.5 %**

N.B.: In phase 2 additional emissions / installations of over 54 Mt are covered. Installations emitting about 30 Mt are only covered it he UK as of 2007, due the opt-out in 2005/06.

http://ec.europa.eu/environment/climat/2nd_phase_ep.htm

A trend towards auctioning

- In the 1st trading period Denmark, Ireland, Hungary and Lithuania decide to auction allowances
- So far only a few million allowances have been auctioned by Ireland, Hungary and Lithuania – very limited experience
- The 2nd trading period will see more auctioning: Germany (< 9 %) UK (7 %), Netherlands (>4 %), Ireland, Hungary, Lithuania, Austria, Belgium, … – growing experience
- Several Member States will auction left-overs from new entrant reserves in 1st and 2nd trading period
- RGGI rules foresee a minimum of 25 % to be auctioned and several states (incl. New York) consider 100 % auctioning

Regulatory changes / evolutions in 2008 to 2012

- Fine-tuning and improvement of the infrastructure
  - Revised monitoring and reporting rules
  - Revised registries regulation
- Opt-in of the first non-CO_2 emissions
  - Some Member States have requested the inclusion of installations in the fertiliser industry emitting N_2O
- Gradual integration of carbon capture and storage (CCS)
- Increased harmonisation of the coverage of combustion installations (e.g. chemical crackers)
- Aviation will be integrated into the EU ETS as of 2011 – Commission proposal of December 2006

Soon the political focus will shift to the third trading period!

Review of the EU ETS in view of the emerging international climate regime post-2012:

Fine tuning and optimisation of the design.

Extension of coverage.

Internationalisation of the EU ETS.

The carbon market coming to age.

Timeline for ETS review

- Review report „*Building a global carbon market*“ released in November 2006
- Stakeholder consultation in a dedicated group under the ECCP umbrella – first half 2007
- Commission prepares a proposal to amend the ETS Directive – end 2007 (as part of integrated climate and energy policy implementation package)

The EU ETS remains Europe’s central instrument to tackle climate change post-2012!

Focus areas for the review

- The scope of the Directive
- Further harmonisation and increased predictability
- Robust compliance and enforcement
- Links to third countries

Focus is needed to allow for high-quality review.

http://ec.europa.eu/environment/climat/emission/review_en.htm

Highlights in the ETS review

- Harmonise cap-setting: timing and procedure for setting EU-wide cap
- Harmonise allocation: increased (mandatory) use of auctioning, possibly benchmarking in some sectors
- Harmonise new entrants: establishment of an EU-wide reserve or no reserve
- Extended periods for cap-setting and allocation
- Expand coverage: N_2O, CCS etc.
- Link to emerging schemes (RGGI, California, Norway, Australia etc.)
  - possible emergence of a US ETS

The EU-wide cap in phase 3

- When is it determined?
- How is it determined?
- How high is it?

Phase 1	Phase 2	Phase 3
2180 Mt	**1964 Mt***	**?**

*Assuming Portugal‘s proposed cap is accepted.
All figures for EU-25, without aviation, extension of scope from phase 1 to phase 2 by over 50 Mt.

How to allocate post-2012?

- There is no silver bullet!
- Allocation has significant distributional implications – this makes the exercise “interesting”.
- NAP-1 and NAP-2 experience provides valuable lessons about overly complex allocation rules.
- Both auctioning and free allocation based on benchmarks are considered.
- There is growing interest in comprehensive auctioning.

May we live in interesting times.

R.F.K., Cape Town, 1966.

Ex-ante benchmarking

- Is a variant of free allocation reflecting the efficiency characteristics of installations
- Is perceived as fairer than grandfathering based on historic emissions
- Is a significant technical challenge in terms of data needs
- Is a significant process challenge in terms of agreeing EU-wide benchmarks
- Is only feasible in a simplified manner
- Is likely to be unfeasible across the board, unless radically simplified

Auctioning

- Is a way of selling allowances into the market
- Is probably the simplest from the administrative point of view (no data needs)
- Is raising revenue
- Is a technical challenge in terms of sound auction design
- Is only feasible across the board with a comprehensive post-2012 agreement in place
- Is a way to avoid undue distributional advantages for those sectors passing through the allowance value

To summarise

- The introduction of the EU ETS in 2005 is a major achievement and signifies a paradigm shift in Europe's climate policy.
- It is important to keep in mind that the first period of the EU ETS was established as a learning period for regulators and companies alike.
- The second trading period will see improvements in many areas
- The review of the EU ETS is aimed at further improvements and extension of the scheme.
- The EU ETS is followed closely across the world and a successful scheme is therefore of strategic importance for the post-2012 climate architecture.
- The internationalisation has started and will proceed over the second trading period and beyond.

More info on EU climate policy: http://europa.eu.int/comm/environment/climat/home_en.htm