

EU Emissions Trading Scheme

Background

- Emissions Trading offers the potential for a lower cost method of reducing carbon emissions than a tax or regulated limits. Experience with such schemes elsewhere has been mixed, although some schemes have been highly successful.
- The EU Emissions Trading Scheme (EU ETS) will operate in phases. The first phase began on 1st January 2005 and runs until the end of 2007. A second, five-year phase will follow in 2008.
- The scheme will address carbon dioxide in the first phase and may be extended to include trading of other greenhouse gases in the second phase.
- The scheme will begin to address environmental costs and stakeholders that are currently not covered by other economic instruments.

What is it? How does it work?

- It is intended that EU ETS will provide a mechanism for member states to meet their national targets under the burden sharing agreement of the Kyoto Protocol. The second phase of the scheme aligns with the Kyoto period for meeting these targets, and it is anticipated that national allocations for the second phase will be set accordingly.
- The EU scheme is mandatory for clearly identified sectors. Industries covered by 'equivalent' domestic measures are able to opt-out until the second phase in 2008 when no opt-outs will be allowed. Power generators, which are excluded from the UK ETS, are therefore included in the EU scheme from 2005.
- The scheme operates on a 'cap and trade' basis. The size of the cap for each phase is determined by individual member states in their National Allocation Plans (NAPs), which specify the number and distribution of emissions allowances across participating sectors. Individual installations that emit more than their initial allowances must buy further allowances from the market. Installations that emit less than initially allocated can sell excess allowances to the market.
- Member states may auction up to 5% of the allocations in the first period and 10% in the second period. However, in the first phase most allocations have been provided free of charge.
- Allowances are reserved for new entrants to the scheme. Mirroring this, when existing installations close they are required to surrender their unused allowances.
- In the UK installation allocations have been made on the basis of historic emissions, where available, with new and recent entrants being benchmarked.
- Penalties for non-compliance are €40/tCO₂ for the first phase of the scheme, and €100/tCO₂ in the second phase, both significantly above the likely market price of permits in the scheme.
- In April 2004 the UK government submitted to the EC its provisional NAP for Phase I, which required a reduction in CO₂ emissions of 5.5Mt against business-as-usual (BaU) projections over the three-year period. All of these reductions were sought

from the electricity generation sector. The EC approved this provisional NAP.

- However, the government subsequently revised its NAP, in October 2004, to include higher BaU projections and higher overall allocations. The net result of this was that greater reductions were sought from the generation sector, totalling 42.1MtCO₂, against the *revised* BaU values.

- In April 2005 the EC formally rejected the UK's revised NAP. However, the UK government announced its intention to pursue legal proceedings against the EC. It will issue allocations on the basis of the revised submission but with a further reduction from the electricity sector such that the UK total equals the provisional NAP value. Any additional allowances resulting from the legal challenge will be allocated to the power sector.

British Energy's position

- British Energy welcomes the introduction of the EU ETS as a means of achieving the lowest cost carbon dioxide emissions reductions.

- The UK is likely to meet its Kyoto commitment without additional measures, however, the company believes that the UK government should set tougher emissions reductions for Phase II consistent with its domestic objectives of a 20% reduction on 1990 levels.

- These longer-term reductions should involve reductions from all sectors, not just electricity supply, although the relative burden should be determined based on the achievability of reductions in each sector.