

Brussels, 4 March 2004

Questions & Answers on Emissions Trading and National Allocation Plans

(updated version as of 6 January 2005)

1) What is the aim of emissions trading?

The Emission Trading Scheme¹ (ETS) is a cornerstone in the fight against climate change. It is the first international trading system for CO₂ emissions in the world. It covers some 12.000 installations representing close to half of Europe's emissions of CO₂.

The aim is to help EU Member States achieve compliance with their commitments under the Kyoto Protocol. Emissions trading does not imply new environmental targets, but allows for cheaper compliance with existing targets under the Kyoto Protocol. Letting participating companies buy or sell emission allowances means that the targets can be achieved at least cost. If the Emissions Trading Scheme had not been adopted, other – more costly – measures would have had to be implemented.

2) What will be the price of allowances?

The Commission has no view on what the price of allowances should be. The price will be a function of supply and demand as in any other free market. Market intermediaries already quote prices for allowances offered or bid for. The Commission will not intervene in the allowance market. Should distortions occur, competition law would be applicable as with any other market.

3) What is the purpose of national allocation plans?

The National Allocation Plans (NAP) determine the total quantity of CO₂ emissions that Member States will grant to their companies, which can then be sold or bought by the companies themselves. This means each Member State must ex-ante decide how many allowances to allocate in total for the first trading period 2005 to 2007 and how many each plant covered by the Emissions Trading Scheme will receive. The idea is that Member States limit CO₂ emissions from the energy and industrial sectors through the allocation of allowances, thereby creating scarcity, so that a functioning market can develop later and overall emissions are then really reduced.

Each Member State had to prepare and publish a NAP by 31 March 2004 (1 May 2004 for the 10 new Member States).

¹ Directive 2003/87/EC

4) Based on which criteria does the Commission assess the allocation plans, and how much time does it have for this?

The assessment of the allocation plans is based on the 11 common criteria in Annex III to the Directive on Emission Trading.

The first criterion provides that the proposed total quantity of allowances must be in line with a Member State's Kyoto target. This means that a Member State should make sure that the allocations that they grant their plants will allow it to meet its Kyoto target.

Of course, the Member State can and should also take other measures. Other sectors also generate greenhouse gas emissions: in the EU, transport is responsible for 21% of EU greenhouse gas emissions, households and small businesses for 17% and agriculture for 10%. So, Member States can and should also take measures to reduce emissions in these sectors. In addition, Member States can plan to purchase emission credits through Kyoto's flexible project-based instruments Clean Development Mechanism (CDM) and Joint Implementation (JI) and international emissions trading under the Kyoto Protocol. CDM and JI allow governments to implement emission-reduction projects abroad and count the achieved reductions against their own Kyoto targets. JI projects can be undertaken in other industrialised countries with Kyoto targets, while CDM projects can be hosted by developing countries, which under the Protocol have no targets.

All these measures and their projected results must be mentioned in the allocation plans. Under criterion 1 the Commission assesses whether the emission levels of the industries that participate in Emission Trading, alongside these other measures, will enable the Member State to meet its Kyoto targets. As only the combined effect of different policies and measures will allow Member States to achieve their targets, the Directive speaks of the "path" to Kyoto. A number of criteria also ask Member States to assess emissions developments and potentials for reductions in all sectors.

In addition, there are criteria that seek to ensure non-discrimination between companies and between the different sectors as well as compliance with the EU's competition and state aid rules. Other criteria relate to provisions in the plan for new entrants, the accommodation of early reduction efforts and clean technology.

The Commission published guidance on the implementation of these allocation criteria in early January 2004. If the Commission finds that a plan is not in line with the criteria and the EU Treaty it can, in part or in full, reject it. If the Commission has not rejected any aspect of its plan, the Member State can proceed to take a final allocation decision. The Commission's decision has to be taken within three months from the date a Member State notifies a national allocation plan to the Commission.

5) Does this mean that a Member State cannot issue as many allowances as it wants?

Yes. The quantity of allowances a Member State may issue is governed by the 11 criteria. The Directive does not explicitly prescribe a given number of allowances, but each Member State must respect the criteria.

This means that in practice their leeway is limited. If a Member State were over-generous in issuing allowances, not only would the plan probably be failing to comply with some of the allocation criteria, but the Member State would also miss out on the opportunity to use the Emissions Trading Scheme as a tool to help it comply with Kyoto. And if too many allowances were issued, there would be no scarcity so no market would develop.

6) How many plans has the Commission assessed so far?

On 7 July 2004, the Commission concluded the assessment of a first set of eight plans. It accepted five plans unconditionally (Denmark, Ireland, the Netherlands, Slovenia, Sweden), and partially rejected the other three - those of Austria, Germany and the UK.

On 20 October 2004, the Commission concluded the assessment of a second set of eight plans. It accepted 6 plans unconditionally (Belgium, Estonia, Latvia, Luxembourg the Slovak Republic and Portugal), and conditionally approved the other 2 - those of Finland and France.

Late December 2004, the Commission concluded the assessment of a third set of five plans. It accepted four plans unconditionally (Cyprus, Hungary, Lithuania and Malta), and conditionally approved the Spanish plan. This brings the number of assessed plans to 21.

In each case of conditional approvals, the Commission indicated the steps that need to be taken by the Member State to make the plan fully acceptable.

7) For what reasons did the Commission require changes to plans?

The Commission identified problems in three areas of general importance:

- if the allocation chosen by a Member State for the 2005-2007 trading period jeopardises the achievement of its Kyoto target (excessive allocation)
- if the volume of allowances for the 2005-2007 trading period is inconsistent with assessment of progress towards the Kyoto target, i.e. the allocation exceeds projected emissions
- if a Member State intends to make so-called "ex-post adjustments" to allocations. This means that the Member States plans to intervene in the market after the allocation is done, and redistribute the issued allowances among the participating companies during the 2005-2007 trading period.

Excessive allocation can result from various cases:

Firstly, where a Member State does not reason how the Kyoto target in 2008-2012 would be respected, but left a gap to be closed with measures to be defined later.

Secondly, where a Member State states the intention to purchase Kyoto credits, but does not demonstrate credible and reliable steps to realise these purchases.

Thirdly, where a Member State bases its plan on projections (including economic and emission growth rates) that are inconsistent and exaggerated compared to official growth forecasts by the Member State itself or other impartial sources.

Ex-post adjustments are incompatible with the legal framework and represent interventions that disrupt the market and create uncertainty for companies. For example, if a company faces the possibility that the government may take away allowances after it has reduced its emissions, it will hesitate to do so.

And if companies think they can receive additional allowances for free from their governments, they will pursue this route rather than turn to the market and buy allowances.

8) What happens if the Commission rejects a national allocation plan?

A rejection of a national allocation plan means that the Member State may not proceed to implement the plan as it stands, i.e. may not allocate the number of allowances proposed. The Commission must give reasons in any rejection decision. These reasons will give guidance to the Member State on how to make the plan compatible with the allocation criteria.

If the Member States whose plans were partially rejected implement the proposed changes they will not have to submit their plans to the Commission a second time, but automatically qualify for emissions trading.

9) Can a Member State change the plan after Commission approval?

After the approval of the Commission a Member State has to proceed to take a final allocation decision at national level. Before doing so, it can make changes to the number of allowances for individual plants as a result of improved data, e.g. if historic emissions data are used for a plant-level allocation formula. A Member State may, however, under no circumstance increase the total number of allowances it intends to put into circulation.

Once the final allocation decision at national level has been taken and the final plan is published no more changes whatsoever to the number of allowances in total or per plant can be made. The final allocation decision concludes the allocation process and opens formally the market for allowances in the Member State.

10) Do Member States have a say on each other's plans?

While the Commission has the sole responsibility to assess the plans, the Directive provides that the Climate Change Committee, consisting of Member State representatives, considers each plan. This Committee is a forum to debate each plan. The Commission, as the Committee's chair, is following this debate and takes the conclusions into account in its assessments.

As a general point, the Climate Change Committee has stressed the importance of national allocation plans to ensure the functioning and effectiveness of the EU Emissions Trading Scheme and maintain and strengthen the EU's international leadership and credibility on climate change.

11) What about the remaining plans?

The assessment of the plans of the Czech Republic, Italy, Greece and Poland is underway and will be concluded as soon as possible in 2005. The decisions taken so far have created a stable and predictable environment, as the Commission will apply the same approach and principles to the assessment of further plans.

It is in the interests of all Member States to have a cleared plan. Not having a national allocation plan accepted by the Commission means that the industry of that Member State would be able to access the EU-wide allowance market only with a delay, even though the targets under the Kyoto Protocol and the burden sharing agreement need to be met.

Furthermore, companies covered by the Emissions Trading Scheme need to record and report their CO₂ emissions as of January 2005. They also need to deliver for the first time in April 2006 a sufficient number of allowances to cover emissions during 2005. If a company delivers no allowances – or not enough allowances - a sanction of €40 per non-delivered allowance will be imposed by the Member State.

12) How many installations are covered?

The Emissions Trading Scheme will cover a total of more than 12,000 installations in the EU-25 (combustion plants, oil refineries, coke ovens, iron and steel plants, and factories making cement, glass, lime, brick, ceramics, pulp and paper).

In larger Member States some 1,000 to 2,500 plants are covered, while in most other Member States the number of plants covered tends to range from 50 to 400.

The number of companies affected by the Directive is obviously smaller, as large companies have many plants covered by the trading scheme.

13) What is the role of participating companies, Member States and the Commission once the scheme has started?

Starting 1 January 2005 companies will have to keep track of their emissions and produce at the end of each year a report on annual emissions that will be verified by a third party (similar to an auditor verifying the financial accounts of a company). At the same time they will have to make sure that they are in possession of a sufficient number of allowances to surrender year by year (first surrender date is end of April 2006) so not to be subject to financial sanctions.

Member States will have to issue allowances by the end of February each year in accordance with the final allocation decisions, operate the national registry, collect verified emissions data and make sure that a sufficient number of allowances is surrendered by each company. Each Member State will also have to produce a regular annual report to the Commission.

The Commission will operate the European hub of the registry system, and prepare an annual report on the basis of Member States reports. It will follow the performance and review the experience with the EU Emissions Trading Scheme closely. In accordance with the Directive, the Commission present a report to Council and Parliament by 30 June 2006. In preparation of this report the Commission will seek input from stakeholders.

14) How much will it cost to reach the Kyoto targets? Will the Emissions Trading Scheme jeopardise Europe's competitiveness?

It depends on the set of measures chosen. One of the underlying principles of the European Climate Change Programme has consistently been to identify the most cost-effective measures to achieve the Kyoto targets. Recent Commission studies conclude that the targets can be achieved at an annual cost of €2.9 to €3.7 billion, which is less than 0.1 % of GDP in the EU. One of these studies concluded that without the Emissions Trading Scheme costs could reach € 6.8 billion. So emission trading allows the costs of Kyoto to be reduced even further.

How these costs are distributed will depend on the decisions taken in the allocation plans and on further measures adopted to control emissions in sectors not covered by the Emissions Trading Scheme. The scheme will not jeopardise, but rather protect, the competitiveness of the EU economy, as any alternative measures would mean imposing higher than necessary costs on EU businesses. Implementing Kyoto will, however, mean not only new economic opportunities but also costs for EU businesses. This is unavoidable – we cannot have something (i.e. Kyoto compliance) for nothing. Europe gets the best value for money with the Emissions Trading Scheme. If governments do not use the trading scheme to assist compliance, more costly measures will have to be imposed on other sectors. Costs have to be seen in relation to the opportunities arising for suppliers of clean, low-carbon technologies in Europe and beyond and the medium-term advantage for European industry in the transition to a low-carbon global economy.

The recently adopted “Linking Directive”² will further lower the costs and protect the competitiveness of EU businesses. As its name implies, the Linking Directive will create a link between the Flexible Mechanisms of the Kyoto Protocol - Joint Implementation (JI) and the Clean Development Mechanism (CDM) - and the EU emissions trading scheme.

In principle, companies which carry out emission reduction projects outside the EU through JI or CDM will be able to convert the credits they earn from those projects into allowances that can be used for compliance under the EU Emissions Trading Scheme. The Linking Directive will therefore further lower the cost to EU industry by offering more options for complying with the requirements of the Emissions Trading Scheme.

15) Will emissions trading lead to higher electricity prices?

It is important to distinguish between the target and the instrument in this debate. Changes in electricity prices will not be a consequence of emissions trading, but of implementation of the Kyoto Protocol. The Kyoto Protocol sets a cap on allowable greenhouse gas emissions, which means that the EU economy will be a carbon-constrained economy in the future. This carbon constraint gives value to the allowances and leads to changes in relative prices in the EU economy. Goods that contain more carbon will be relatively more expensive than goods that contain less carbon.

As the trading scheme is the cheapest way to implement Kyoto, it means that any price changes will be the lowest necessary. Many studies have been put forward about the likely development of power prices and a wide range of estimates are available.

Pricing decisions in the liberalised power market are increasingly complex and difficult to predict. There are many events that directly affect the electricity price, emission trading is just one of them. There are structural aspects such as the liberalisation of the energy market and variations in the internal energy market that have very far-reaching effects. The Commission will carefully monitor the development of power prices and all other aspects related to the Emissions Trading Scheme.

² Directive 2004/101/EC of the European Parliament and of the Council of 27 October 2004 amending Directive 2003/87/EC

16) How will companies benefit from emissions trading?

Let's say that companies A and B both emit 100,000 tonnes of CO₂ per year. The government gives each of them 95,000 emission allowances. One allowance represents the right to emit 1 tonne of CO₂. So, neither company is fully covered for its emissions. At the end of each year, the companies have to surrender a number of allowances corresponding to their emissions during the year, whatever the emissions of the individual company are. Companies A and B both have to cover 5,000 tonnes of CO₂, and they have two ways of doing this. They can either reduce their emissions by 5,000 tonnes, or purchase 5,000 allowances in the market. In order to decide which option to pursue, they will compare the costs of reducing their emissions by 5,000 tonnes with the market price for allowances.

For the sake of the example, let's say that the allowance market price is € 10 per tonne of CO₂. Company A's reduction costs are € 5 (i.e. lower than the market price). Company A will reduce its emissions, because it is cheaper than buying allowances. Company A may even reduce its emissions by more than 5,000 tonnes, say 10,000 tonnes. For Company B, the situation may be the opposite: its reduction costs are € 15 (i.e. higher than the market price) so it will prefer to buy allowances instead of reducing emissions.

Company A spends € 50,000 on reducing 10,000 tonnes at a cost of € 5 per tonne and receives € 50,000 from selling 5,000 tonnes at a price of € 10. So Company A fully offsets its emission reduction costs by selling allowances, whereas without the Emissions Trading Scheme it would have had a net cost of € 25,000 to bear. Company B spends € 50,000 on buying 5,000 tonnes at a price of € 10. In the absence of the flexibility provided by the Emissions Trading Scheme, company B would have had to spend € 75,000.

Since only a company that has low reduction costs and therefore has chosen to reduce its emissions, like Company A, is able to sell, the allowances that Company B buys represent a reduction of emissions, even if Company B did not itself reduce emissions.

This is important to remember. This ensures that the cheapest reductions are made first. Since the scheme is EU-wide, companies will seek out the cheapest reductions in the whole of the EU and ensure that they are made first. It is this flexibility in the system which makes emissions trading the most cost-effective manner of achieving a given environmental target. The overall cost to industry would have been higher if Company B had been forced to reduce emissions at its own plant at a higher cost.

17) How will allowance trading work in practice?

The legal framework of the trading scheme does not regulate how and where the market in allowances takes place. Companies with commitments may trade allowances directly with each other, or they may buy or sell via a broker, bank or other allowance market intermediary.

It could also be the case that a company purchasing a fossil fuel (coal or gas) will be offered allowances in combination with the fuel. Finally, organised markets (allowance exchanges) may develop.

There will also be an electronic registry system. This registry system is separate from trading activity - not all trades result in changes in ownership of allowances, but where a trade culminates in a change in ownership there will be a transfer of allowances between accounts in the registry system.

In this way, the registry system is similar to a banking system which keeps track of the ownership of money in accounts but does not track the deals made in the goods and services markets which were the cause of the money changing hands. So the registry system is not a marketplace; the way in which allowances are traded is a decision made by the participants in the market.

The system will be purely electronic, and so allowances will not be printed on paper but exist only in an online registry account. Each company with a commitment and any person interested in buying or selling allowances will need an account. The system will consist of a national component in each Member State where the allowances are held and a hub at European level, which will conduct automated checks on each transfer of allowances to ensure that the rules of the Directive are respected. Some of the data held in the registry will be released periodically, in accordance with UN rules and a forthcoming Regulation. A balance will be sought between environmental transparency and commercial confidentiality.

See also:

<http://europa.eu.int/comm/environment/climat/emission.htm>

http://europa.eu.int/comm/environment/climat/emission_plans.htm