

EU ETS: Learning the Lessons

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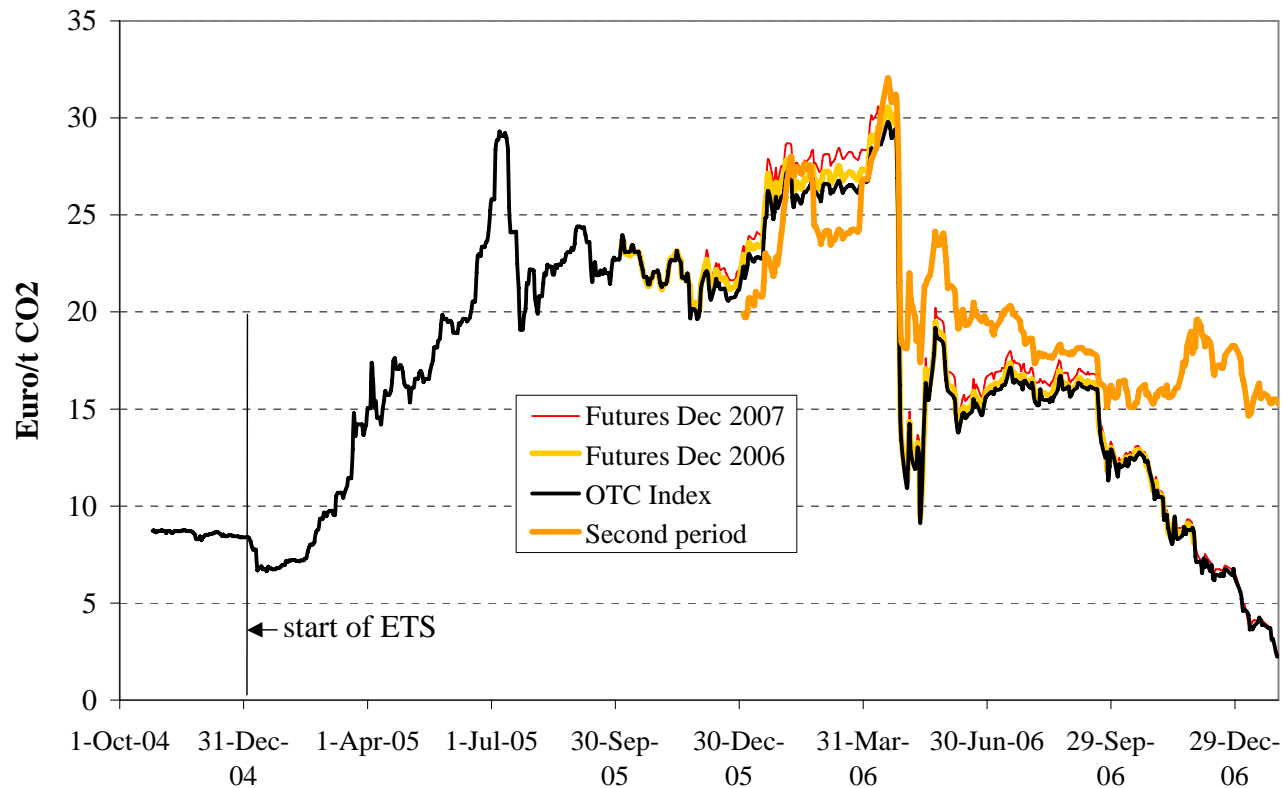
EU ETS Phase I:

proves success in market design and verification,
reveals important lessons on pricing, profits ..

- An EU-wide market that gives value to company efforts to reduce CO2 emissions, and incentivises them to seek out the least-cost means of doing so
- The market mechanics have worked well – extensive trading through various mechanisms
- Stringent verification requirements have proved effective and valuable
- .. But raise questions about the threshold of 20MW and related transaction costs ..
- Phase I confirms the predictions that some sectors (notably electricity) profit from the combination of free allowances and passing through the opportunity costs
- .. The biggest lessons of all concern allocation and projections..

Biggest lesson from Phase I: allocation is central, projections are unreliable, few people understand the fundamentals, and many had incentives to “talk it up”

EUA price 25 October 2004-30 January 2007

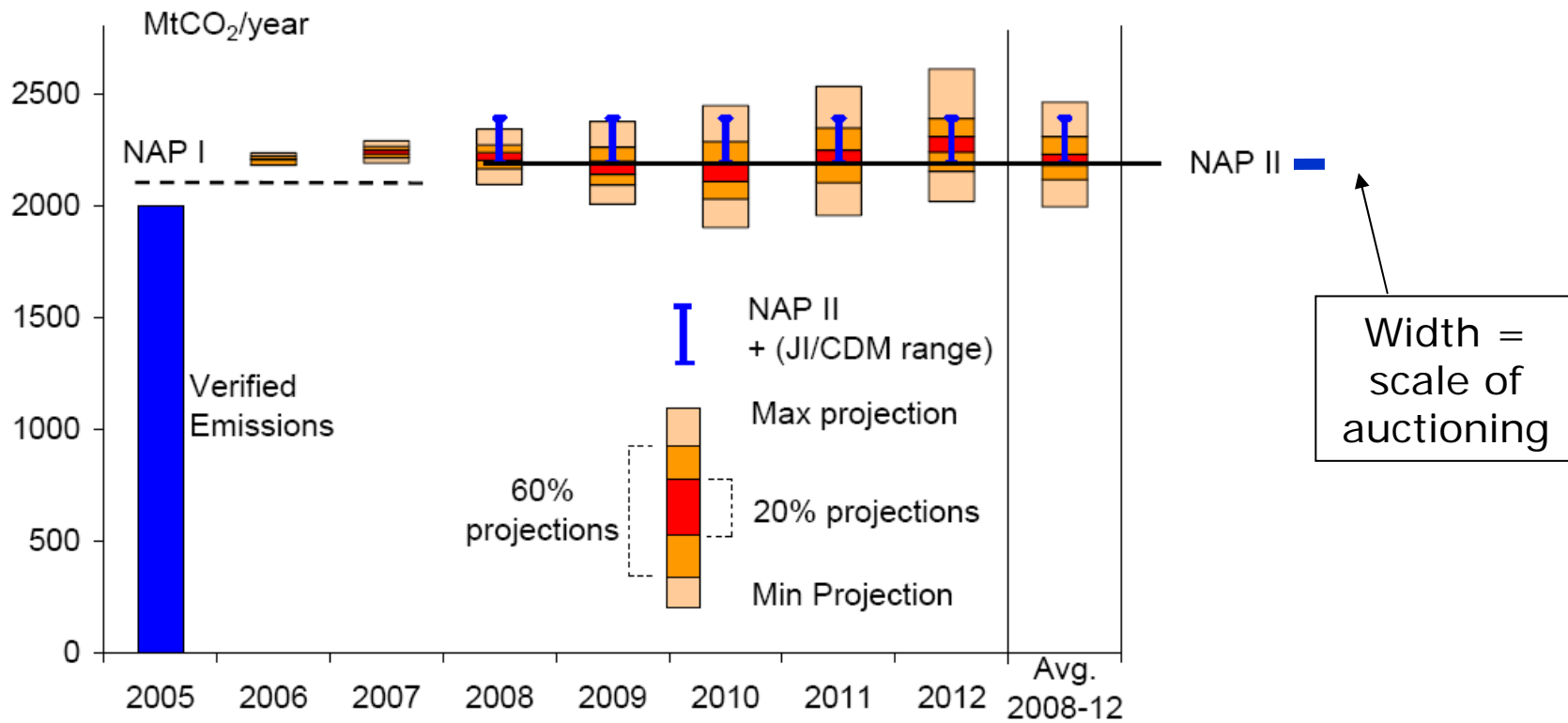


*“We compare Phase I allocations against historical emissions, projections and Kyoto targets .. they are **excessive on all these measures** ... we note the UK ETS [also] had a price spike early in its operation before prices collapsed to near zero towards the compliance date ...”*

- Grubb, Azar and Peterson, *Climate Policy, Vol.5 no.1, April 2005*

Submitted/draft Phase II NAPs offered cutbacks much smaller than projection uncertainties, low chance of significant carbon price (negligible if JI/CDM committed) - auctioning volumes too trivial to stabilise the market

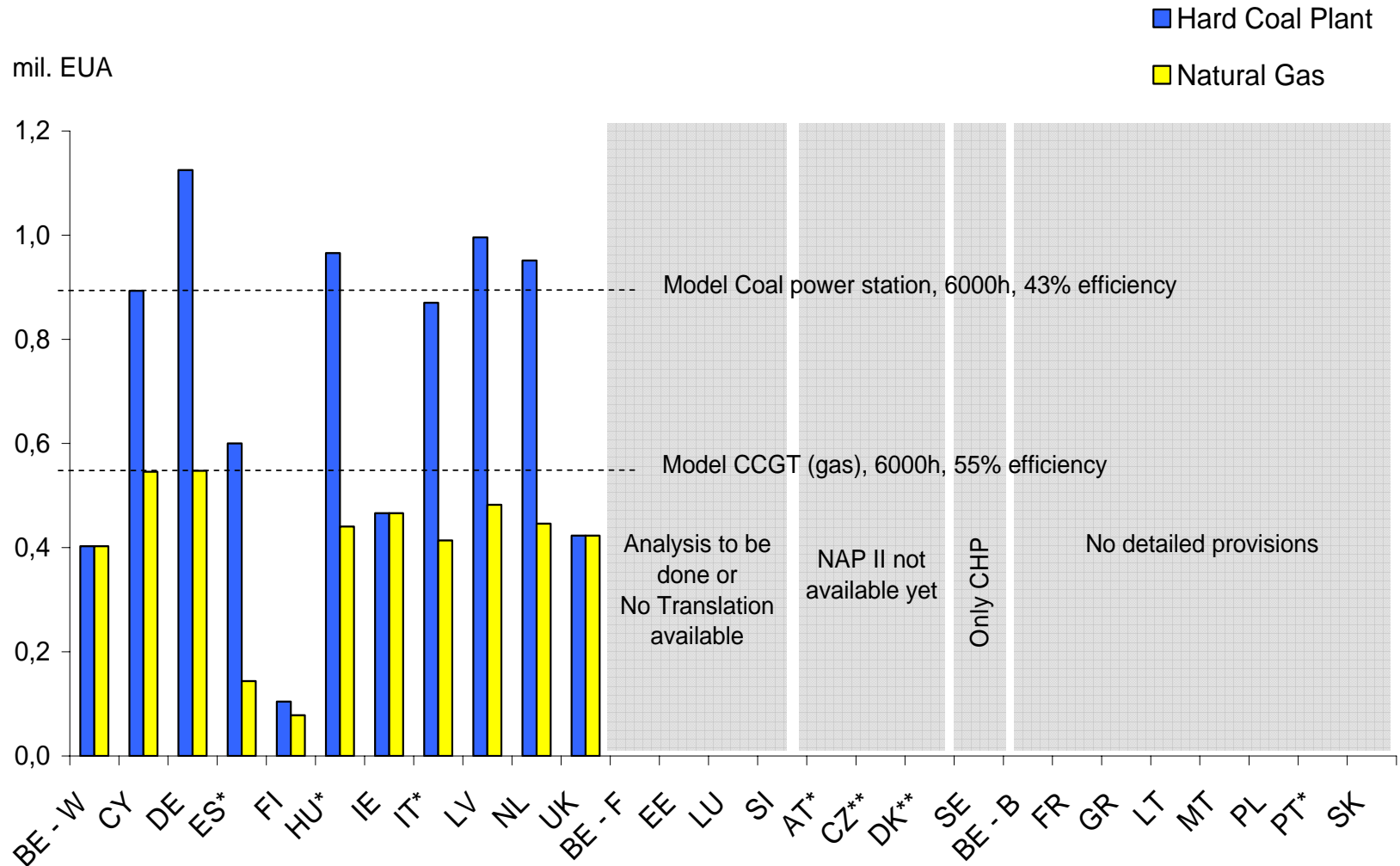
Projected emissions vs. Cap, when the power sector is exposed to 20€/t CO₂ price



Source: Neuhoff, Ferrario, Grubb, Gabel, Keats (Sept 2006)

New entrant details matter, a few benchmarked but *many Phase II proposals no better than Phase I*

- German NAP provided the biggest perverse incentive subsidies for new coal (the more it emits, the bigger the subsidy)



Generic lessons from Phase I, and implications of submitted / draft NAPs

Highly imperfect as a model, but could still be the “carbon dollar”?

- Phase I successfully achieved core aims of establishing credible market infrastructure, engaging the target community, and yielding lessons
- Slow pace of learning, and negligible knowledge transfer from research to governmental or industrial policy (EC learning faster and more comprehensive)
- Huge gap between the lessons & recommendations of economic analysis and the practical application to Phase II NAPs, particularly concerning:
 - Overall allocation
 - Distortions from the new entrant and closure provisions
 - The economics of pricing and auctions
- Approval of submitted / draft NAPs (as of Nov 2006) would have created:
 - Weak Phase II EU ETS market, dependent entirely upon the progress of post-2012 negotiations (affecting both perceptions and value of banked allowances)
 - Investments deferred
 - JI and CDM become almost exclusively public-sector mechanisms, funded by taxpayers, not through private sector rents
 - Heavy pressure on Treasuries for funding Kyoto compliance
- EU ETS at present is *not* a model for other countries, but continues to be a source of valuable lessons that will influence other designs, and a “focal point”

Investment security and avoidance of perverse incentives requires stronger NAPs, more auctioning, and early clarification of post-2012

Build on phase 1 successes and lessons:

Phase II

- Beware inflated projections, give less allowances than projected need, and differentiate by sector
- Benchmark where possible – differentiated by tech for incumbents, but not for new entrants
- Maximise use of auctioning – reduces distortions, stabilises governmental commitment, & minimum price auctions enhance security of low carbon investment

Extend scheme to create certainty and move towards greater auctioning. If no global carbon price, could protect competitiveness through:

Post 2012

- International linkage and sector carbon agreements
- Border tax adjustments
- “Retrospective” output based allocation

- *ETS Review needs to consider all options*

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ETS Special Issues of *Climate Policy* journal:

Allocation and competitiveness

Vol.6 no.1, June 2006

Phase I Lessons and Phase II analysis

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national allocation plans in the EU emissions trading scheme

LESSONS AND IMPLICATIONS FOR PHASE II

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