

### Introduction

The EU Emissions Trading system is the most extensive example of cap and trade regulation of greenhouse gases in existence to date. It began in 2005 with a two year preparatory phase and is now in its first formal phase (beginning in 2008 and ending in 2012). The rules governing the scheme post 2012 have been agreed but are conditional on UN climate agreements.

The EU System offers rich evidence on what works and what doesn't work in the design of an effective cap and trade policy. This briefing highlights the key lessons from the EU's experience for policymakers and civil society in countries currently considering implementing their own emissions trading systems, and for the development of a global carbon market.

### About Sandbag

Sandbag is a UK based not-for-profit campaigning organisation dedicated to achieving real action to tackle climate change and focused on the issue of emissions trading.

Our aim is educate and inform civil society about emissions trading policy, to scrutinise how it is working on the ground and to lobby for improvements. In doing this we seek to involve civil society more in the operation and future development of emissions trading.

### Lesson 1: Start with the power sector and other sectors not exposed to international competition

The EU system has worked much better for the power sector than for industries exposed to international competition. It is much easier to impose tough caps on power generation which cannot, like industry, threaten to relocate their operations abroad. Indeed, at the moment, the power sector in the EU is required to deliver greater emissions cuts than the system as a whole as industrial sectors have been allowed to continue increasing their emissions. The system would actually work better in the short term with internationally competing industries taken out.

Sectors which supply fossil fuels for heating and transport also lend themselves to caps as they too can pass on costs to consumers with relatively little risk of demand shifting overseas.

### Lesson 2: Auction permits, don't give them out for free

So far the EU has given out emissions permits to polluting installations for free. The problem with this is that the allocations were based on predicted future emissions which are notoriously difficult to get right, especially in the event of global economic downturns. The process also gives powerful business and industrial interests a perfect opportunity to lobby politicians for generous allocations. Free allocations create the risk of companies making windfall profits without making effort to cut their emissions. With auctions of permits, companies only buy what they need, and the auctions generate valuable revenues that can be spent on addressing any regressive impacts of the system, on adaptation or on research and development into climate change solutions.

**If just half of Phase 2 permits had been auctioned EU would have made €70 billion in revenues to be spent on green investment**

### Lesson 3: Don't believe the scare stories – err on the side of ambitious targets.

There are always a lot of people ready to say that emissions trading will ruin industry, will result in job losses, will put thousands of Euros



onto fuel bills. EU politicians who believed these scare stories gave industrial sectors such generous allocations that they will make profits from the emissions trading system in the short term.

And the high prices predicted for carbon have not transpired. Of far greater concern has been the low price of carbon, not providing the incentives for green investment and green jobs that many had hoped for. Industry scare stories should be treated with a degree of scepticism as evidence has shown that price predictions are not borne out in practice since the market is very efficient at sourcing low cost solutions. Policy makers should err on the side of tougher caps but with safety valves built in such as creating a limited offsetting provision to use emissions credits generated in uncapped sectors.

Another way to reduce costs is to increase the scope of the trading system by linking to other similar systems. Increased scope increases the availability of abatement options preventing price spikes.

Finally, it is possible to reduce the likelihood of high prices in the emissions trading market by introducing supportive policies. For example for the deployment of renewable energy and increased energy efficiency.

All of these 'safety valves' are preferable to the setting of weak caps based on low environmental ambition.

#### 4. Remember why the market was set up – and hold onto powers to improve it

Many market analysts advocate a 'laissez faire' approach to emissions trading systems once they are set up. But as in many traded markets, investors and businesses can deal with any uncertainty and volatility as long as the rules are transparent. Emissions markets are artificially constructed by politicians to cut emissions, and in the case of the EU - to contribute its share of keeping the world below a warming of 2 degrees. All policymakers need to retain powers to revise a policy if it is not achieving its aims – emissions trading is no different. The EU tied its hand behind its back by leaving its self too few powers to adjust its own system. Reviews should be built in from the start to allow for an increase in ambition. The current recession is a case in point, just as some countries generated surplus AAUs

as a result of the recession in the early 90s, so too the EU will generate 'hot air' surplus EUA permits from today's downturn.

#### 5. Harness the power of civil society – set aside permits for citizen action and make data publicly available

An increasing number of people care about climate change and their personal carbon footprint. Many want to take positive actions, in particular saving electricity in their homes. However, if electricity emissions are capped as they are under the EU emissions trading system, people's own actions don't generate additional cuts in carbon emissions since the caps dictate the level of pollution. If citizens do their bit, they just make it easier for power companies to do a little bit less. Setting aside a pool of permits that can be cancelled if citizens achieve quantified emissions reductions allows people to make a difference, and ensure that the cap isn't a ceiling on how far countries can go in cutting their emissions.

Emissions' trading creates a large amount of information about participants in the scheme. It is important that all data is open to public scrutiny so that civil society can help to monitor how the policy is performing on the ground. Sandbag's website provide a variety of data on the EU ETS including interactive maps on polluting installations.

For a more detailed analysis see Sandbag's full reports:

<http://bit.ly/ETS-SOS>

<http://bit.ly/EU-Ambition>

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