

# Issue Overview:

## Europe's Emission Trading System

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On January 15, 2009, the U.S. Climate Action Partnership (USCAP) issued the *Blueprint for Legislative Action* – a detailed framework for legislation to address climate change. This brief discusses the European Union's Emission Trading System (EU ETS) and the lessons learned for a domestic cap-and-trade program. It should be considered in the context of our *Blueprint*, which includes detailed and integrated recommendations on climate protection legislation.

The recommendations in the *Blueprint* were developed based on review and analysis of past regulatory programs, including lessons learned from the initial problems experienced in the EU ETS. Established in 2005, the EU ETS is the world's first and largest regulated trading system for greenhouse gas (GHG) emissions. The system was designed to have three phases of development:

- An initial “learning” phase (2005 – 2007) in which policy makers and trading system participants could familiarize themselves with the operations and realities of the emissions market;
- A second phase (2008 – 2012) which coincides with the first commitment period of the Kyoto Protocol and thus the first period for which the EU has a binding international emission reduction obligation; and
- A third phase (2013 and beyond) in which the EU and other nations are expected to establish a broad international agreement for GHG reductions. The framework for the third phase has recently been proposed by the EU.

In 2008, the European Commission adopted a number of changes to the system to address issues that were experienced during the system's initial learning phase. These issues have provided lessons for design of similar trading systems, including any such trading system developed in the United States. Key issues and changes include:

- **Caps Greater than Emissions and Limited Banking:** In the first phase, policy makers overestimated both actual and projected GHG emissions. As a consequence, the EU established emissions caps that were higher than overall regulated emissions levels. As this flaw became clear, carbon prices crashed. Additionally, as there was no banking of allowances between the first and second phases, the resulting carbon prices fell further. To avoid this problem, the *Blueprint* recommends aggressive emissions reductions based on accurate emissions data and unlimited banking of allowances through at least 2050.
- **Limited Scope of Coverage:** The EU ETS covers 40 percent of all GHG emissions and 46 percent of CO<sub>2</sub> in Phase Two. That level will increase in Phase Three. The *Blueprint* recommends a much broader scope of coverage which we estimate will cover approximately 80 percent of U.S. GHG emissions.
- **Excessive Free Allocation:** The EU ETS allocated most allowance value to emitters. This allowed some entities such as electric power generators to reap windfall profits as they recovered the market value of some of these allowances in power prices. The EU has reformed the system by building in a transition to auctioning their allowances. Similarly, the *USCAP Blueprint* calls for transitional partial allocations based on net compliance costs only to competitive power generators and other large stationary sources. These partial allocations would phase out over time as low- and no-carbon alternative technologies become broadly deployable. The *Blueprint* calls for additional allocations to go to regulated electric and gas distribution companies, who would pass the full market value of those allocations to customers in an effort to buffer the impact of energy price increases.
- **Importance of Complementary Policies and Measures:** The EU ETS experience underscores the importance of complementing a cap-and-trade system with complementary policies and measures to

drive the adoption and development of low- and no-carbon technologies in all the key emitting sectors. The *Blueprint* dedicates significant allowance value and recommends significant complementary policy measures to support the goals of the cap-and-trade system.

While the system experienced several challenges in its initial pilot phase, the EU has created a functioning market and a price signal to reduce emissions and the flexibility to manage climate policy cost-effectively. These recent decisions by the EU will further strengthen and expand the ETS beyond 2012 to more sectors and gases and ultimately steeper emission reductions by 2020. The *Blueprint* carefully applies these lessons to avoid the initial problems encountered by the EU ETS.

To learn more about the USCAP *Blueprint for Legislation Action*, please visit [www.us-cap.org](http://www.us-cap.org).

*The U.S. Climate Action Partnership is a non-partisan coalition composed of 25 major corporations and five leading environmental organizations that have come together to call on the federal government to quickly enact strong national legislation requiring significant reductions of greenhouse gas emissions. USCAP has issued a landmark set of principles and recommendations to underscore the urgent need for a policy framework on climate change.*