



**Friends of
the Earth**

**Friends of the Earth Consultation Response
EU Emissions Trading Scheme
UK National Allocation Plan 2005-07**

Summary

We are extremely disappointed that the UK's domestic climate and energy policies and targets (of a 20% reduction in CO₂ by 2010) have not formed the basis for total allocation of allowances in the first phase of the EU ETS in the UK.

The UK NAP in context

It must be remembered that we had all but met our Kyoto target by the time Kyoto was signed. Our national target is therefore a far fairer yardstick against which to compare our allocation plan against other European countries. In that respect our current allocation plan compares unfavourably with other countries. In relation to our national 20% target we have over-allocated to the traded sector making meeting the target entirely unrealistic. This seriously undermines both our credibility as a leader on climate change and our calls for tough action from the Commission on other countries' NAPs.

This sets a damaging precedent within Europe and contributes to making the market as a whole long. It is clear that UK industries have the technological potential to go far further than a 0.02% reduction on the baseline years for the scheme (or 3% reduction on 2002 levels). It is likely therefore that they would seek to sell, however, every country will seek to ensure their industries are also sellers and there is a very real risk that both liquidity and the price of carbon will collapse.

The absence of banking in the first phase exacerbates this risk. The net effect could easily be that the UK and Europe as a whole becomes locked into a zero-reduction pathway for the best part of the remainder of this decade. The availability of uncapped CDM and JI credits further adds to this risk making a net increase in EU emissions entirely possible. The ramifications of this for international negotiations for the second commitment period are extremely serious.

The over allocation

Even using the revised projection for UK 2010 CO₂ emissions of a 15.2% reduction (from 1990) our initial analysis of the current plan (in summary below) shows over allocation in the first phase of trading of between 1.5MtC and 5.6MtC.

The root cause of the problem

The basis of the agreement between DTI and DEFRA regarding the principles of allocation (ie that 1.5MtC would be subtracted from Business As Usual Projections (with measures)) is flawed and the DTI's revised energy projections have now seriously undermined the environmental outcome of the UK draft NAP published in February. The target should have been made relative to baseline emissions not expressed as a set amount of carbon.

Pegging the ambition for the scheme to figures first published in the Climate Change Programme in 1999 was also inappropriate. The basis for the CC Programme, Energy Paper 68, is now long out of date as the latest UEP figures clearly illustrate.

Quantifying the over allocation

The current draft allocation plan covers 46% of the UK's carbon dioxide emissions. In 2002 we were 8.7% below our 1990 CO₂ emissions levels needing to make a further 11.3% reduction (18.6 MtC) by 2010 to meet our 20% target. Even if we are aiming for only a 15.2% reduction by 2010 then savings of 10.7 MtC across all sectors need to be made.

NAP allocation

The current NAP proposes only a 3% reduction on industrial emissions (a 0.2% reduction on the baseline years) which is 2 MtC off 2002 levels by 2007.

To reach the 15.2% target from now until 2007 a 'fair share' requirement on industry calculated by proportion of emissions would be 3.5 MtC.

This would require emissions in other sectors (domestic and transport) to be reducing in equal proportion. However emissions in these sectors are currently rising. If however we assume they can be stabilised to reach our target then industrial emissions would need to reduce by the full amount eg 7.6 MtC

1990 baseline = 164.6 MtC

2010 15.2% target = 25MtC reduction

2002 achievement to date = 14.3MtC

Gap = 10.7 MtC

46% = 4.9MtC

2002- 2007 contribution (linear path) = 3.5 MtC

Assuming no decline in transport and domestic emissions = 7.6 MtC

So in scenario 1: aiming towards a 15.2% reduction with equal savings across all sectors the NAP allocates 1.5MtC too many allowances to industry.

In scenario 2: aiming towards a 15.2% reduction with transport and domestic emissions remaining static the over- allocation is 5.6MtC too many.

Correcting the mistake

Relative targets

We believe the level of ambition for the scheme must be made relative to projected baseline emissions (ie as a percentage reduction) to enable us to achieve our environmental targets relative to 1990. Not to adopt a relative target for the ETS will mean we have to introduce more costly additional emissions reduction measures to correct rising emissions.

Challenging unrealistic projections

To prevent over-allocation DTI's energy projections must be fully scrutinised and justified - we are sceptical that projected emission levels will in reality ever occur - particularly in the iron and steel sector where a 7% pa growth is being predicted.

We are also concerned that the increase in allowances to the off-shore oil and gas sector establishes a dangerous precedent whereby decreasing efficiency resulting in higher per unit emissions is being rewarded with an increased allocation (without compensating reductions within other sectors).

Increasing ambition

We strongly believe that in light of the publication of the revised energy projections, which may even now be revised upwards taking us ever further from the 15.2/20% 2010 target, the 1.5MtC reduction from BAU should be revisited and increased. According to our calculations it should be at least doubled to keep emissions line with the stated 15.2% reduction by 2010.

To help frame discussions surrounding increasing the ambition it is essential that DTI publish their BAU projections with a price for carbon included with appropriate sensitivity analysis. Only then can we assess the adequacy of the 1.5MtC as a reflection of the anticipated effect of the scheme (see below).

Use of New Entrant Reserve

An alternative suggestion would be to use the New Entrants Reserve to achieve a higher level of ambition by cancelling rather than auctioning any surplus allowances at the end of the period. This would serve to increase the incentive for new entrants which in turn should help to reduce energy intensity – particularly if challenging benchmarks are adopted.

Other countries have adopted this approach including Germany and Ireland so it would not have an adverse effect on competitiveness.

It would have the additional benefits of removing a market shock from the trading scheme and reducing administration complexity and costs. Arguably an auction at the end of the first trading period in a market that is long and with no banking would provide little additional benefit to industry anyway. The auction could also be perceived by industry as a stealth tax – particularly targeted at the electricity generators as there has been no indication that revenues will be recycled. Deciding not to hold the auction may therefore prove to be the most politically acceptable route to reducing over-allocation.

Internalising cost of carbon

The DTI energy projections take into account many factors that will effect future energy demand and emissions.

They include the effect of measures to reduce emissions that have already been introduced - so called 'certain' measures.

Although the model includes the effect of different commodity prices for coal, gas and oil it does not include the effect of the price of carbon on demand for these fuels. This is despite the fact that it is certain that a price will exist and already does exist both for UK emissions trading scheme allowances and the EU allowances.

The DTI argue that their BAU model does not need to include carbon prices as they have incorporated the effect of the EU ET scheme by subtracting a set amount of carbon off the BAU baseline (eg 1.5 MtC). However this applies only to the power sector and cannot therefore be said to properly internalise the cost of carbon on all sectors.

The net effect of this approach is that the DTI's BAU projections will in reality never be achieved and the allocations therefore are higher than industry will need. This puts the UK's NAP in breach of Annex III of the Directive which states that industry must not be allocated more allowances than it needs.

Responses to consultation questions

We are concerned that in considering the detail of allocation the broader principles relating to how emissions trading can deliver environmental outcomes have been forgotten.

We have not had the resources to answer all of the questions raised in the consultation and have therefore concentrated our efforts on those issues which relate not to distributional effects between sectors and installations but to the overall environmental outcome of the scheme.

New Entrants

As discussed above we feel that the underlying energy projections that underpin the NAP are overly optimistic and the plan currently over allocates to industry. We consider a high New Entrants Reserve to be absolutely essential in these circumstances as it at least provides an incentive for industry to open

in new plant when they might otherwise chose to increase load factors at existing plant which are likely to be more carbon intensive than new plant.

The rules governing the new entrants reserve are therefore important for the overall environmental outcome of the scheme.

We believe the NER should:

- be large – 7.7% appears appropriate but could be made higher;
- include a ring fenced reserve for CHP calculated as a straight line extrapolation from the Government's 10GW 2010 target;
- be accessible to only newly commissioned plant;
- not be made available for any changes in output or efficiency in existing plant – this would undermine the whole point of the trading scheme;
- not be used to compensate for the fitting of FGD – again this goes against the principles of the trading scheme which is designed to reduce the carbon intensity of production;
- use benchmarks to calculate allowances which are not fuel specific but reflect BAT efficiency standards – for the power sector CCGT could be used or an industry average for plant installed in the last 10 years.

Other remarks

Verification – requiring operators to obtain verification of baseline data by accredited verifiers is arguably insufficiently robust to ensure the integrity of the scheme and Government should also introduce harsh penalties for false submissions. The verification of baselines must result in emissions data which are consistent with previously submitted data under the IPC regulations administered by the Environment Agency and published annually in their Inventory of Pollution. Any deviations must be fully explored as the submission of correct data is a legal requirement for both systems.

Coal Mine Methane – we believe these installations should be zero rated until methane emissions are included in the EU ETS.

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