



## POSITION PAPER

### ON IMPLEMENTATION IN THE UK OF PHASE 2 OF THE EU GREENHOUSE GAS EMISSIONS TRADING SCHEME (EUETS)

1. The first phase of the EUETS, as prescribed in the European Commission's Directive 2003/87/EC (13 October 2003) came into force on 1 January 2005 and will run until 31 December 2007. The UK Government has decided that the Power Generation Sector will be the only sector within Phase 1 of the EUETS that will suffer a significant shortfall in its allocation of CO<sub>2</sub> emissions allowances compared to those that it is projected to require if it continues to operate on a "business as usual" basis.
2. Based on the UK National Allocation Plan (NAP) that was approved by the European Commission in July 2004 (including allowances for Phase 1 totalling 736 MtCO<sub>2</sub>) existing installations in the Power Generation Sector will be allocated about 130 MtCO<sub>2</sub> a year during 2005-2007. If emissions from the Sector remain at the 2004 level in the period 2005-2007, generators will be over 100 MtCO<sub>2</sub> short during Phase 1. The Government announced on 11 March 2005 that it will mount a legal challenge to obtain the Commission's agreement to issue an additional 20 million allowances in Phase 1. If that action were successful, a further 20 MtCO<sub>2</sub> would be issued to the Power Generation Sector, but the outcome is highly uncertain and does little to alleviate the difficult situation in which the Sector finds itself.
3. The inequitable reduction in CO<sub>2</sub> emissions allowances which will be borne by the Power Generation Sector in Phase 1 should be taken into account when setting the allocation for the Sector in Phase 2. In particular, in the event of the inclusion of other sectors in Phase 2, the Government should ensure that all sectors contribute equitably towards emissions reduction targets, rather than placing the burden solely on power generation.
4. The table below shows the Sector's contribution to the reduction of CO<sub>2</sub> emissions since 1990. CO<sub>2</sub> emissions from power stations decreased by 15.5% between 1990 and 2004 (DTI Energy Trends, March 2005).

| <b>Annual CO<sub>2</sub> emissions (MtCO<sub>2</sub>)</b> | <b>1990</b>  | <b>2003</b>  | <b>2004 (provisional)</b> | <b>% change 1990-2004</b> |
|---|--------------|--------------|---------------------------|---------------------------|
| Power Stations  | 204.4        | 174.7        | 172.5                     | -15.5                     |
| Other Sectors   | 402.6        | 398.2        | 408.8                     | +1.5                      |
| <b>UK Total</b>   | <b>607.0</b> | <b>572.9</b> | <b>581.3</b>              | <b>-4.2</b>               |

Source: DTI Energy Trends, March 2005. (Note: MtC converted to MtCO<sub>2</sub> using factor 3.67)

5. The policy context for the reduction of CO<sub>2</sub> emissions is centred on the UK's commitment under the Kyoto Protocol to reduce greenhouse gas emissions by 12.5% below 1990 levels by 2008-12 and the Government's national goal to move towards a 20% reduction in CO<sub>2</sub> emissions below 1990 levels by 2010. The means to achieve both of those objectives are set out in the UK Climate Change Programme 2000, which will be reviewed in the first half of 2005.
6. Phase 2 of the EUETS will run from 1 January 2008 to 31 December 2012. NAPs have to be submitted to the Commission by the end of June 2006, so the Government must decide how to implement Phase 2 during 2005. The Association wishes the following points to be taken into consideration when the Government formulates the UK NAP for Phase 2:
  - The implementation of the EUETS needs to be set in the context of a coherent suite of policy instruments that define the Government's strategic approach to climate change. That suite of instruments, taking account of policy set out in the Energy White Paper from February 2003, should be summarised in the 2005 Climate Change Programme (CCP 2005). In view of the long lead times for investment in power generation, it is important that there is sufficient clarity in the Government's long-term planning to allow the Power Generation Sector to deliver the substantial investment programme needed to reduce CO<sub>2</sub> emissions and maintain electricity supplies in the period to 2020.
  - The CCP 2005 should include a robust assessment of progress on greenhouse gas emission reductions to date and a realistic analysis of the technical and economic means available to all sectors, both inside and outside the EUETS, to contribute to the Government's environmental goals in both the 1<sup>st</sup> Kyoto compliance period and beyond. This should cover a range of credible scenarios and also reflect uncertainties in what can be delivered in practice by climate change policy instruments. Based on that analysis, the Government should set the overall level of ambition for emissions reduction for the UK and the expected contribution from the traded sector, and state them in the CCP 2005.
  - The Government needs to state clearly whether its emissions reduction targets are based on physical reductions in the UK alone or whether

they may be met through a combination of technical and economic compliance.

- There is not enough time for power station operators to invest in equipment to achieve the physical reductions required in Phase 1, or sufficient scope for them to make the necessary reductions by switching fuels from coal to gas, so operators will have to purchase allowances to achieve compliance. The Government should recognise the costs and risks of a policy that requires the wholesale purchase of allowances from the market when it is unclear if mechanisms exist to bridge the gap between the supply and demand of allowances.
- A clear programme is needed for the timely development and implementation of the arrangements for Phase 2 of the EUETS, so that operators can take full account of the implications in their business plans. Finalisation of the NAP and allocation of allowances should not be left until the eleventh hour, as has happened in Phase 1.
- We would welcome full consultation and early involvement in discussions about the possible allocation methodologies that could be adopted in Phase 2.
- The Association welcomes the recent indication from the Government that if the allocation of allowances for Phase 2 is based on historical emissions, the baseline should not include data from 2004 onwards as that may cause a perverse incentive for operators to increase emissions during Phase 1.
- The Government's approach of making the Power Generation Sector solely responsible for all cuts in emissions in the EUETS, and for making good under-achievement in the non-traded sector, is inequitable and cannot practically deliver the Government's target of 20% reduction in CO<sub>2</sub> emissions by 2010.
- Whilst the UK may be in a position to meet its Kyoto target, it is unlikely to meet its domestic 20% CO<sub>2</sub> reduction target by 2010. The UK should avoid any knee-jerk reactions to that setback and should consider making use of all available measures to mitigate the potential shortfall rather than expecting the EUETS to deliver all of the increasingly demanding domestic targets, especially when this would lead to increased energy costs for all UK consumers; this would have political implications and would increase the risk of UK firms being uncompetitive in international markets.
- It is important that the modelling of energy projections guides, rather than determines, policy on EUETS, and provides a means to identify possibilities for corrective action, if required, in the future. A transparent process is needed for the revision of the Updated Energy Projections which must ensure appropriate industry participation at all stages and improve on the NAP process for Phase 1.
- The potential for transboundary market distortion should be minimised through improved transparency and co-ordination of the NAP process across the EU. The Government should work with the Commission and Member States to promote harmonisation where consensus can be

achieved ahead of finalising the NAPs for Phase 2. This could include key elements such as monitoring, reporting and verification.

- While we support the inclusion of other sectors and gases in principle, provided this is both practical and cost beneficial, the extension of the scope of the EUETS in Phase 2 is likely to divert attention from the priority tasks of simplifying the allocation process and resolving anomalies in the current methodology. It would be more appropriate to establish a programme for the collection of data and development of monitoring methodologies to enable the EUETS to be extended post 2012. The Government should avoid acting unilaterally to extend the scope of the EUETS in Phase 2.
  - It is ultimately for the Government to determine the level of domestic ambition in achieving greenhouse gas reductions. However, there should be no additional limit on the quantity of credits that can be used from Joint Implementation (JI) and Clean Development Mechanism (CDM) within the EUETS. We expect that practical constraints on the availability of JI and CDM credits will limit their use for compliance, especially if the integrity of JI and CDM projects is kept at an appropriately high level.
7. The Association recognises that the Power Generation Sector will continue to play a major role in the Government's strategy to reduce UK greenhouse gas emissions, but it cannot continue to bear the burden of the policy alone. We are ready to work closely with the Government to ensure the successful operation of the EUETS and to help to develop suitable policy measures to achieve UK Government targets on climate change.

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