

## **Emissions Trading: UK Government Vision**

The Stern review of the economics of climate change confirms that climate change is real and that it is a global problem needing a multilateral solution. The review finds that:

- The impacts of climate change on growth and development could be much higher than previously thought;
- Serious impacts will be felt around the world, including in developing countries least able to adapt;
- The costs of global action to mitigate the most dangerous effects of climate change are significant but manageable, as long as action is taken multilaterally, with flexibility to respond to new scientific and economic information; and
- Action is urgent – the earlier we start, the greater the chance we will have of limiting the risks of dangerous climate change and the cheaper it will be.

The review highlights the need for a carbon price signal across countries and sectors to ensure that emission reductions are delivered in the most cost-effective way. Tax, trading and regulation can all be used to create a price for carbon. Whatever carbon pricing instrument is chosen, credibility, flexibility and predictability are vital to effective policy design.

An international carbon trading system keeps emissions within limits whilst allowing emission reductions to be made at least cost through the trading of allowances. This is the UK's carbon price instrument of choice and a key component in a comprehensive UK policy framework to effectively mitigate climate change.

The EU, with a strong lead from the UK, has built on the Kyoto Protocol to take the world's most significant step in that direction by establishing the EU Emissions Trading Scheme. The UK is committed to building on the EU ETS as its main way of pricing carbon in the economy, to ensure that emissions are effectively limited. The scheme already covers approximately half of the UK and EU's carbon dioxide emissions, including emissions from electricity production. Its introduction in 2005 has led to the creation of a growing carbon market, valuing carbon by placing a limit on the overall quantity of carbon dioxide which can be emitted. Links to project credits from developing countries through the Clean Development Mechanism increase opportunities for emissions savings to be made at the point of least cost and drive financial flows and investment in low carbon technology in these developing economies.

It is important to get the design of the scheme right. The more we can trade emissions reductions across international borders, and the more emissions that are covered, the more cost effective for all it will be to achieve challenging emissions reduction targets. These targets need to be set internationally; and the EU needs to lead that debate, balancing both the EU's international

competitive position and the need to provide EU businesses with greater certainty on the carbon constraints that will face the EU economy, so they can make the right investment decisions. Making the carbon market deeper, wider and more liquid will increase its effectiveness in delivering greater emission reductions, and do so at least cost.

With the right focus, the EU ETS can become the basis of a global carbon market, benefiting the world by creating a more secure international framework, expanding the coverage of ambitious, quantified emissions reduction targets, and tackling concerns about international competitiveness. To ensure sufficient scarcity in the global market, caps must be set so as to deliver those reductions.

It is vital to ensure the scheme meets the needs of consumers, business, and the environment, and provides flows of investment in low carbon technologies to developing countries. **The Government will discuss the lessons of the Stern review with business and environmental stakeholders in the UK and with decision makers in the EU and internationally. It hopes to develop a widely shared UK approach to the future development of the scheme and to use that consensus to help take forward the debate with our EU partners. In particular, it would like to discuss how to make progress in the following areas.**

### **Setting safe, stable and affordable emissions limits**

**First, to ensure we are on the right course to stay within limits, and to give businesses the confidence to invest in reducing emissions, the EU should:**

- **Identify the level at which greenhouse gas concentrations in the atmosphere need to be stabilised, and negotiate internationally to secure agreement to a future international framework which will achieve this.** As the Stern review finds, this is both necessary to avoid dangerous climate change and achievable as long as action is taken multilaterally. The EU has a long-term global goal of limiting global average temperature increase to no more than 2°C above pre-industrial levels;
- **In line with this goal to stabilise global greenhouse gas concentrations, commit to reducing greenhouse gas emissions across the EU as a whole to at least 60% below 1990 levels by 2050, including domestic action and contributions made by EU companies and Member States to the efforts of developing countries, for example using the Clean Development Mechanism;**
- **Agree at the 2007 Spring European Council options for a post 2012 framework of commitments, with a view to reaching international agreement as a matter of urgency;**
- **As an interim step in the EU, commit to reducing greenhouse gas emissions across the EU as a whole to 30% below 1990 levels by**

2020, including domestic action and contributions made by EU companies and Member States to the efforts of developing countries, for example using the Clean Development Mechanism;

- **Commit to building on the EU ETS as the EU's principal mechanism of reducing carbon emissions;**
- **Provide a predictable and transparent mechanism to revise EU emission goals in the light of international commitments and the latest scientific and economic evidence;**
- **Commit to ensuring there is scarcity in the EU ETS to enable these goals to be delivered.**

### **Building a global carbon market**

**Second, to bring about emissions reductions at lower cost and more effectively, the global carbon market should be made deeper, more liquid and with wider coverage. Therefore, the EU should consider expanding the scheme to:**

- **Cover more sectors and gases:** We welcome the Commission's actions to cover aviation and it should explore expansion to other emission sources to avoid the need for more costly measures at Member State level: for example, we have asked the Commission to examine the feasibility of including surface transport;
- **Link with schemes in other countries to develop a truly global carbon market:** An increasing number of countries and regions are developing and proposing emissions trading schemes (e.g. Norway, Switzerland, Japan, and state-level schemes in the US and Australia). Properly constructed links to such schemes would increase the liquidity of the carbon market, and benefit all participants and the wider public interest;
- **Alongside emissions reductions in the EU, encourage EU firms to invest in emissions reductions in developing countries** by expanding and scaling up the use of instruments such as the Clean Development Mechanism. This would benefit developing countries, the EU and the world by driving financial flows and transfer of low carbon technology to developing economies, reducing global greenhouse gas emissions at least cost. To aid this, while negotiating a broader and deeper framework, **the EU should guarantee that credits from Clean Development Mechanism projects registered by 2012 will be valid for compliance in EU ETS phase 3**, bringing forward investment in emission reductions.

### **Improving efficiency**

**Third, the EU should consider further technical changes to improve the efficiency of the scheme:**

- **Options to provide greater certainty on medium term requirements on business**, including consideration of the optimal length of trading

periods and the options for providing firms with clear signals about their own future position;

- **Ensuring the scheme does not distort the internal market** so that there is a level playing field with no adverse impacts on competitiveness, including through robust systems for taking decisions on allocations and caps;
- **Moving towards more auctioning of allowances in future phases** to ensure a more efficient allocation;
- **Removing perverse incentives where there is free allocation of allowances** through more standardised methodology;
- **Making the scheme more targeted and ensuring it meets better regulation principles:** for example, by removing small emitters from the scheme could substantially reduce overall administrative burdens and improve scheme cost-effectiveness, with minimal impact on overall emissions coverage.

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