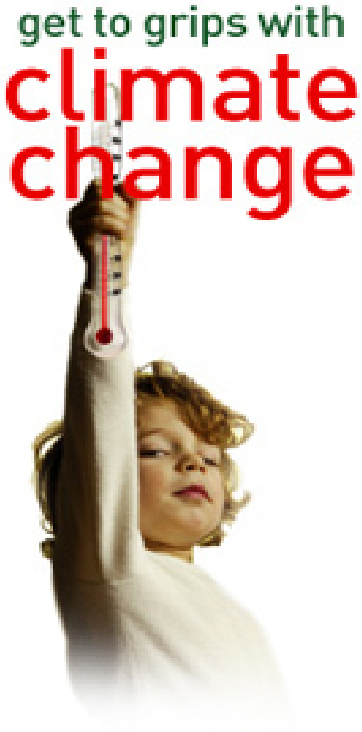

An update on the EU ETS

Bonn, 24 May 2006

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Overview

- State of play after the first year
- Preparing for the second trading period
- Review and the EU ETS beyond 2012

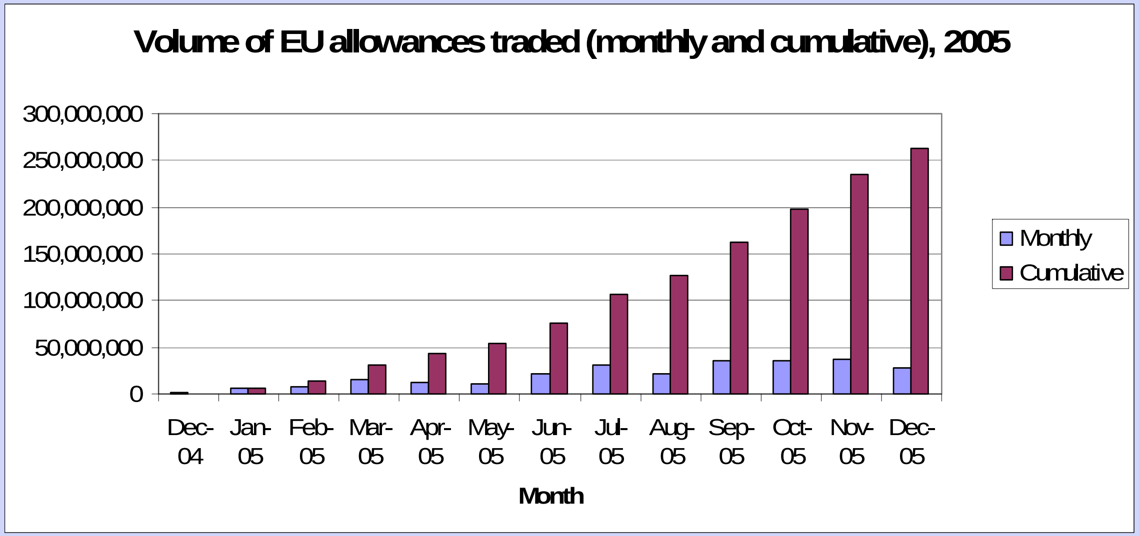
The EU emissions trading scheme

- ✓ Over 10,000 installations across EU-25 monitoring their CO_2 emissions
- ✓ Culture change: environmental issue also becoming a financial issue
- ✓ Modern environmental tool: least-cost solution promoting energy efficiency/operational changes, take-up and improvement of clean technologies over time
- ✓ Will contribute towards fulfilment of the Kyoto Protocol
- ✓ World's largest emissions trading scheme: nucleus of international carbon market

State of play after the first year

EU ETS – the first year

- Started on time on 1.1.2005 – since then carbon has a price
- 22 registries are online, many new private sector players entered the carbon market
- Trading increased steadily during 2005: in total more than 320 million allowances were reported traded representing a value of around $US 8.2 billion
- EU companies and Member States are also contributing to an active project mechanisms market. 372 million CDM credits were reported traded in 2005 representing a value of around $US 2.7 billion. Member States will need at least 500 million tons CO_2eq. from the flexible mechanisms.



2005 an unusual year?

- Market has operated in the absence of systematically verified emissions data
- Registries were brought online in a gradual fashion – hampered the spot market
- Historically unprecedented oil (and also gas) prices
  - Which have pushed up power prices across the world (e.g. also in the US)
- Outstanding knowledge gaps in business are overcome gradually and internal arrangements are slowly put in place in companies to use the allowance market

Ensuring compliance

- Compliance is vital for the success of the instrument, as it underpins the economic value of the allowances
- First annual compliance cycle is running, and by …
- 31 March 2006 verified emissions data must have been submitted by each company to national authority
- 30 April 2006 allowances for 2005 verified emissions must have been surrendered
- 15 May 2006 verified emissions data per installation displayed on the CITL

Preparing for the second trading period

Assessment of NAPs

- Process is the same as in the first period

- Directive gives the Commission three months to assess the compatibility of a notified NAP against the criteria in the Directive

- 11 criteria are unchanged, one criterion has been added via Linking Directive

- A Commission Decision will be adopted on each plan

Draft NAPs are available at

http://europa.eu.int/comm/environment/climat/2nd_phase_ep.htm

Belgium (Flemish Region)

Germany

Ireland

Latvia

United Kingdom

Bulgaria

Framework for NAP-2

- Directive remains stable
- Leaves flexibility
- A lot of experience is at hand
- Original Commission guidance
- Supplemented by further Commission guidance to build on experience and recommend sound choices within the given legal framework

Key elements of Further Guidance

- Main lessons from first trading period
- Timely submission of allocation plans is important
- Next period plans should be simpler and more transparent
- Determining the total quantity of allowances
- Clarification on scope and definitions (combustion installations and small installations)

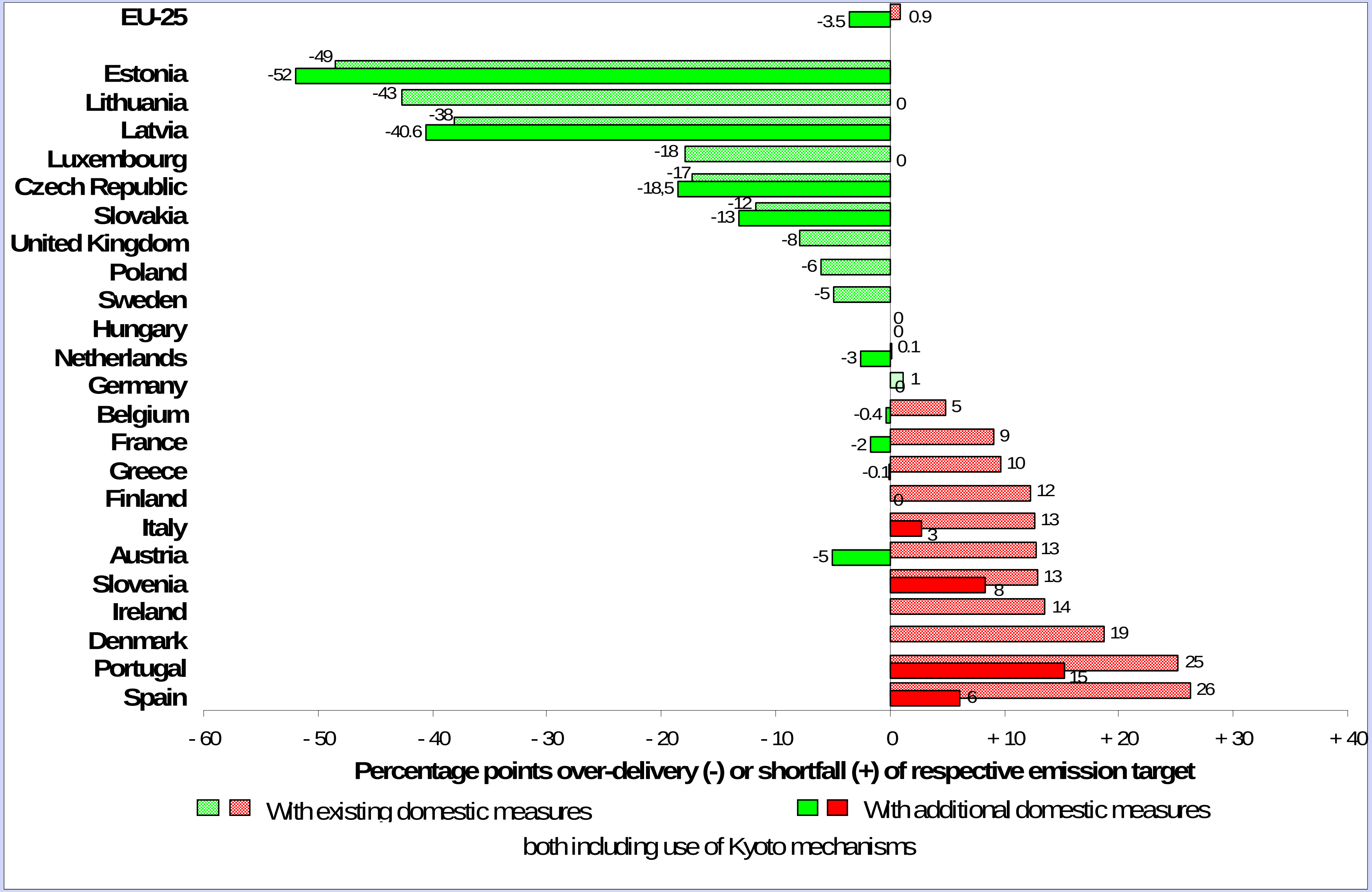
Main lessons learnt

- More use of emissions trading is necessary to meet the Kyoto targets cost-effectively
- Allocations have in general been more restrictive for power generators
- Member States experiencing considerable excess in actual emissions intend to purchase a substantial amount of Kyoto units
- The avoidance of ex-post adjustments is important for the allowance market development
- Some allocation plans are more complex than necessary and not sufficiently transparent

Simplicity & Transparency

- Simpler allocation plans boost understanding among authorities and stakeholders alike and improve predictability
- MS are invited to question unnecessary administrative rules decided in the first period
- Standardised tables improve transparency: They summarise key data and assumptions relevant for the NAP assessment in a common format for all Member States

Implementation challenge ahead: Some Member States need more ET



National allocations

- A considerable number of Member States have gaps to close between 2003 overall emissions and those allowed under the Kyoto target.
- The total gap for these Member States sums up to 296.5 million tonnes.
- These Member States therefore need to allocate less in the 2nd period.
- All Member States should take aggregate 2005 verified emissions data into account.
- If the trading sector carries a proportionate burden, the EU-cap would be about 6% lower. In this calculation, the aggregate 2005 verified emissions data will be taken into account.

Combustion installations

- Currently different interpretations of “combustion installation” in different Member States

  ⇒ distortion of competition on the internal market

- Important to have consistent coverage in the future

  ⇒ Focus on larger emitters in markets where there is potential for significant distortions of competition

- All MS should at least include crackers, carbon black, flaring, furnaces and integrated steelworks. Further specifications to be provided.

- Inclusion of additional small installations not priority at this stage.

The smallest installations

- Some participation costs incurred by the smallest installations are "one-off" costs in the run-up to the 1st trading period
- Recurring costs are largely related to monitoring, reporting and verification – particular consideration has been given to this in the review of the MR Guidelines
- Importance of using simpler allocation rules for the 2nd trading period in order to benefit the smallest installations
- Member States should explore all existing flexibilities offered by the Directive with respect to the smallest installations
- Will be considered in the overall review of the EU ETS

Review and the EU ETS beyond 2012

What the review is about

- Improve the functioning of the scheme based on practical implementation experience
- Streamline current scheme …
  - More predictable allocation rules through
    - stable baseline years and/or
    - longer allocation certainty and/or
    - derive future allocation from past allocation
  - More harmonised approach to new entrants and closures, based on experience during 2005-07 period
  - Further harmonisation of accreditation and verification
- …and expand to other sectors and climate change impacts, beyond aviation

What the review is not about

- Not about the 2nd trading period
  - Allocation plans are decided this year
  - Directive can not be amended before the start of the second period
  - Regulatory stability calls for appropriate lead-time for changes in the design of the scheme
- Not about whether or not the EU ETS should be continued post-2012: it will continue
- Not about change for the sake of change
  - but based on examination of the costs and benefits of scheme design changes

What is needed for a good review?

- Sufficient practical evidence on …
  - allocation
  - market activity
  - compliance (monitoring, reporting, verification, sanctions)
- Active input from a range of stakeholders
  - Member States
  - Covered industry
  - Other industry
  - Market intermediaries
  - NGOs
  - Academia

Main results of the EU ETS survey
(McKinsey and Ecofys, 2^{nd} half 2005)

- EU ETS has an impact on corporate behaviour – all sectors price in value of allowances
- Long-term topics have highest priority for all stakeholders
- However no clear consensus – harmonise allocation, but how?
  - Companies want longer allocation certainty (ten years or more)
  - Benchmarking seen as interesting alternative, however most companies think more than 3 benchmarks per sector are needed
  - More auctioning disliked by companies but favoured by other stakeholders
- Wide consensus that scheme design changes should be brought in with sufficient lead-time

Concluding thoughts

- The EU ETS is an economic instrument to address an environmental problem
- Europe is leading the way in turning the concept of market-based climate policy into reality and a continent-wide carbon price signal has emerged.
- The EU ETS in its current shape is the first step in an evolution to a global carbon market.
- We have learnt, and are continuing to learn a great deal about establishing a carbon market and how it interacts with other markets.
- Focus will remain on keeping it simple. A simple scheme will be more likely to fulfil its promise and provide blueprint for other schemes.

More information on EU climate change policy

http://europa.eu.int/comm/environment/climat/home_en.htm