

## HOW EMISSIONS TRADING WON IN EUROPE

The world's oldest and largest carbon market was established in the EU more than 10 years ago – despite initial reservations about trading by the bloc's policy-makers. Peter Vis explains how the tide was turned

GHG emissions trading came about in Europe first, despite the initial reluctance of the EU towards employing the Kyoto Protocol's "flexibility mechanisms". Why was that so?

The first reason was that emissions trading was not a tax. Europe had been wrestling with the idea of a carbon/energy tax since it took such a legal proposal to the Rio Earth Summit in 1992. Economists usually argue that a CO2 tax is more efficient, being able to cover large swathes of the economy, and more certain with regard to the costs. Revenues would be raised that could be used for good purpose by national governments...

The reason it failed was primarily institutional: the EU's Treaty of Rome required then, as it requires still today, the unanimous agreement of all Member States on taxation issues. Several Member States could not agree to constrain their fiscal sovereignty by introducing such taxes at the European level when they already had such a freedom to act at the national level if they wanted to.

European businesses, as represented by BusinessEurope (called UNICE at the time), were also fiercely opposed to such a tax. They worried for their competitiveness, maintaining that it was certain to increase their costs, and sceptical that any of the revenues raised from industry would be recycled back to them.

When emissions trading was first floated as a possibility in 1998, its major virtue was that it was not a tax. Revenues might be generated if allowances were auctioned, but it was difficult to claim that emissions trading was a tax if allowances were allocated for free. The trading of allowances meant that money was "recycled" within

business sectors. Emissions trading, therefore, avoided being typecast as a tax, although some tried to argue it was.

The importance of this was that the legal basis for emissions trading was the environmental Article of the EU Treaty, given that the primary purpose was to limit GHG emissions. Institutionally, the environmental legal base was of "co-decision", with the European Parliament and the Council deciding together, and the Council taking its position on the basis of a qualified majority of Member States. Crucially, this avoided the need for unanimity. That basic fact changed the dynamics completely, so that one or two Member States could not block the way forward.

There was, however, a second crucial element that helped the introduction of emissions trading. Businesses had welcomed insertion of the "flexibility mechanisms", such as emissions trading, into the Kyoto Protocol. In particular, Article 17 read that: "The Parties included in Annex B may participate in emissions trading for the purposes of fulfilling their commitments under Article 3." Businesses were, however, less enthusiastic about the proviso that followed: "Any such trading shall be supplemental to domestic actions..."

It was not initially envisaged that emissions trading would be by operators; it was widely thought that emissions trading would be between Parties to the Protocol, which is to say between governments. When the European Commission first raised the possibility of emissions trading at company level, it was hard for business to argue that they welcomed the flexibility of emissions trading between governments but not between businesses. Businesses, after all,

### IF SOMETHING WAS TO BE DONE ABOUT CLIMATE CHANGE, IT MADE GOOD ECONOMIC SENSE TO DO THIS IN A "BUSINESS-FRIENDLY" WAY

were the major emitters that governments would have to regulate, and they were also the ones who made investment decisions, so the logic that they should be covered by such an instrument was strong.

In the run up to, and subsequent to, the Kyoto Protocol being agreed in 1997, there were thought to be two ways of fulfilling the targets: by "domestic actions" or by the "flexibility mechanisms". The two were portrayed as alternatives. The more environmentally ambitious governments and green NGOs lined up behind domestic actions, which were generally thought to be such things as command-and-control regulations or taxes, and more liberal governments and businesses lined up behind the flexibility mechanisms.

This "supplementarity" provision had been included at the insistence of the EU, among others. As soon as the European negotiators returned from Kyoto, it became a priority to try and define exactly what this word "supplemental" meant. EU expert groups were convened to elaborate a definition. Many hours of my time were lost discussing how to define supplementarity, which eventually earned the shorthand name of a "concrete ceiling" (reflecting EU Council Conclusions text)<sup>1</sup>.

When eventually agreed in May 1999, the EU went out to sell its definition to others, such as the United States. I recall accompanying my Commissioner, Ritt Bjerregaard, to visit Under Secretary of State for Global Affairs, Frank Loy, in Washington, to try and convince him. We managed to do no such thing, however. Third countries could not understand why we wanted to define supplementarity restrictively, when common sense suggested that it was anything “less than half” of a Party’s effort to fulfil its target. The European definition was horribly complicated, but it amounted to a small percentage of the effort of Parties, and was never accepted by Parties as a whole.

This extended debate lasted a couple of years and took up a disproportionate amount of my time, just when there was much to do in developing the European Commission’s concept of emissions trading. Although few could understand it, what mattered was that in the context of the debate on supplementarity, emissions trading was seen as a “good thing” by the business community, whereas domestic actions were seen as difficult, more costly and constraining. Perception is everything, and the debate unintentionally framed the way businesses viewed emissions trading: they saw that many environmental NGOs were against it, and that economically liberal countries such as the United States were for it, and concluded for themselves that it was not such a bad thing.

Minds were shaped by this debate, so that when the European Commission proposed

## EMISSIONS TRADING AVOIDED BEING TYPECAST AS A TAX, ALTHOUGH SOME TRIED TO ARGUE IT WAS

emissions trading for operators, trusting business know-how would be able to respond more flexibly and cost-efficiently, it was too late for the business community to change its mind and say that emissions trading was bad... They had spent years lobbying for it to be used more rather than less. And, of course, many businesses saw that if something was to be done about climate change, it made good economic sense to do this in a “business-friendly” way.

In retrospect, the definition of supplementarity and the “concrete ceiling” made little impact – except in shaping minds. The EU’s emissions trading system (ETS) was considered a domestic policy and measure within the bloc. The EU unilaterally constrained the use of the “flexibility mechanisms” for its Member States, although not very severely, and the debate about supplementarity moved on as it became clear that the EU Member States did not need much use of international emissions trading and offsets to meet their Kyoto targets. The use of offset credits from the Clean Development Mechanism (CDM) was capped for operators under the EU ETS, but that was partly in recognition that CDM credits do not actually reduce global emissions, but transfer emissions “rights” from one part of the world to another, in exchange for a financial transfer flowing from the purchaser of the credits to the vendor.

So, to summarise, emissions trading happened in Europe more easily because of the extended debate over supplementarity. The polarisation between emissions trading and other “flexibility mechanisms” of the Kyoto Protocol, on the one hand, and “domestic actions”, on the other, made business more willing to embrace emissions trading as we know it today.

Finally, and crucially, emissions trading gave reassurance to both governments and businesses that what had been promised in Kyoto could be delivered cost-efficiently, minimising any burden on European industry. All this proved to be true, and, with ups and downs, emissions trading has stayed the course through its first decade, with every chance of continuing to deliver for the next 10 years and more.

*This article was written by **Peter Vis** while he was the EU Visiting Fellow at St. Antony’s College, Oxford University, for the academic year 2014-15. Prior to that he was Head of Cabinet to Connie Hedegaard, European Commissioner for Climate Action (2010-14). An official of the European Commission since 1990, he worked extensively on developing and implementing the EU’s emissions trading system from 1998-2005.*

(1) For the EU’s proposal on defining a “concrete ceiling” see Council Conclusions on the Environment (paragraph 3) as agreed by the Agriculture Council of 17 May 1999: [http://europa.eu/rapid/press-release\\_PRES-99-149\\_en.htm?locale=en](http://europa.eu/rapid/press-release_PRES-99-149_en.htm?locale=en)

