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Editor's note

Games of poker

A paradox of the present times is that although in Europe some historic steps are taken, the public at large – including the inhabitants of the European Union (EU) themselves – hardly seem to pay attention to it; the 10 June European Parliament elections do not seem to make a difference. To begin with, the enlargement of the EU just a few weeks ago (1 May) has been a major historic event: basically Central Europe, the old Habsburg empire, has become part of the EU. Historically, this reunification (after Europe's abrupt split after WWII) seems to be much more substantial than, for instance, the German reunification of 1990. Yet, relatively few people considered the European reunification on 1 May as the great moment in European history that it actually is.

At about the same time – now that most of the National Allocation Plans (NAP) for the EU emissions trading scheme (EU ETS) have been published, at least in draft form – the EU has effectively been putting in place one unified, EU-wide climate policy regime, which not only creates the largest emissions trading market in the world, but probably also marks the most far-reaching environmental policy effort ever in history. Again, this is a historic event, but when I asked my first-year economics students in the Netherlands about it, most of them said not to know of it.

Finally, the leader of the Eastern European 'empire' Russia, President Putin, stated on 21 May last that *"The fact that the EU has met us halfway in negotiations on the WTO could not but have helped Moscow's positive attitude to the question of ratifying the Kyoto Protocol."* This official statement considerably increases the chances that at some stage he will invite the Duma to ratify the Kyoto Protocol, so that, unless unforeseen events take place, the Kyoto Protocol will become official. It does not, however, come as a complete surprise. As I already argued in my editor's note of December last year, Russia knows that it will benefit considerably from ratification (my guestimate at that time of €15-20bn has not yet been refuted), but it has been playing a game of poker. In a well-played game, one could expect Russia to – albeit not openly – link ratification to other issues (*e.g.* WTO accession negotiations) and leave others with the impression of being rather indifferent with respect to ratification. For instance, by performing a show with some 'bad guys' (incl. Illarionov) who argue that Russia should not ratify at all. If this has been the poker game's strategy, Russian tricks may have worked well because it made many people nervous. And if so, Putin has rightfully won this game, making, by the way, his statement not less historic.

Now, what are the implications of all this?
First of all, the EU ETS has become even more serious business, in particular for the European industry and the power sector (although the European Commission had already made clear that it would to go on with the EU ETS irrespective of Russian ratification of the Kyoto Protocol).

Second, all eyes are now focused on the allocation process because one increasingly realises its impact on the credit market and credit market prices. How will this process work out with 25 NAPs, which together confront some 15.000 EU installations with yearly (non-bankable for a following year) CO_2 allowances? The (draft) NAPs of the larger EU (incl. new) member states have now been notified (with some delay), and some argue that the overall impression is – as expected – that the proposed schedules are not overly tight. Yet, there could be a considerable net demand in the scheme. To give an example, the German 2005-7 allocation of 1509 $MtCO_2$ – which may (at an assumed 1.5% annual emissions growth) lead to a national deficit of some 50 $MtCO_2$ – may well be more or less equivalent to the expected surplus of all the new member states taken together (assuming 5-8% higher than present level allocations and an almost zero actual emissions growth in these countries). In that case, Germany alone could absorb the Central European surpluses leaving the rest of the EU with a net deficit (see also Stan Kolar's comment in *Point Carbon*, 30 April 2004).

Third, it will take some time before clear carbon credit price trends will materialise. This does not come as a surprise given that the 2004 events thus far could not have been more hectic:

- the approval of the EU ETS 'linking directive' (April),
- the submission of the NAPs (March-June),
- the basically new development of the CER and ERU market(s) (early 2004), and finally
- Putin's first serious expression of a 'positive attitude' towards Kyoto Protocol ratification (May).

No wonder that the new, small, forward-trade-based carbon credits market, dominated by energy-sector participants, gets erratic under such hectic circumstances! Moreover, in the meantime, further NAPs are going to be made public, without anyone knowing for sure which schemes the Commission – openly expressing concern about allocations being too generous - will approve (note that Peter Vis of the Commission's DG Environment has recently indicated that he would hate to see the allowance price drop below €5/tCO_2). Also, no wonder that the allowance price dropped from still €13 per tonne in mid-February (when the UK issued its draft NAP, perceived as rather tight) to about €7 per tonne in the course of May following the German NAP, but subsequently increased by €0.25 per tonne in a few hours following just the rumour that the Commission may not accept some NAPs.

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If, by the way, the Commission would decide not to accept (some) NAPs - which would seem tricky from the political perspective anyhow – it is well advised not to use a 'similar percentage reduction across the board approach', because that could completely frustrate the often well-balanced NAPs, fine-tuned on the basis of the national circumstances. Also, this could involve criticism on the Commission of not having been clear enough about definitions (such as of installations) that seem crucial for the overall scheme.

Basically, however, it seems fair to guess, also with a view to the fact that the 'linking directive' effectively places an upper bound to credit prices, that allowance prices may well keep fluctuating between €5 per tonne (lower bound) and €10-15 per tonne (upper bound).

Fourth, a Russian ratification would also raise a couple of new questions, such as: to what extent does it change the thinking about a post-Kyoto regime? Should this basically be a similar regime, or would there still be sufficient arguments for a fundamentally different approach? Another sensitive issue for reflection is whether the non-ratifying USA and Australia could be considered free riders, so that Protocol Parties would – within WTO - legally be allowed to introduce trade policy measures against (energy-intensive) products imported from these countries. *Etcetera.*

Sufficient scope for new poker games.

Catrinus J. Jepma

"Pretty positive about what has been achieved"

Maurits Blanson Henkemans on the EU allocation process

As per 24 May, the European Commission had received fourteen National Allocation Plans (NAPs) for the first period of the EU Emissions Trading Scheme (ETS), 2005-2007 (see Table on p.4 of this issue). Nine of these NAPs came from the fifteen 'old' EU member states (EU-15) and five were submitted by the new member states Slovenia, Latvia, Lithuania, Estonia and Slovak Republic. Of the EU-15 Portugal, Belgium and Italy recently submitted draft NAPs. France, Greece and Spain are still in the process of preparing such a draft.

The fact that only a part of the 25 member states ('old' and 'new') have met the deadlines for submission (31 March 2004 for the 'old' and 1 May 2004 for the 'new' member states) could give rise to concern about the progress with allocating emission allowances across European business. On the other hand, it should not be overlooked that the overall allocation is a complicated task for European governments and surrounded by several political sensitivities. In order to acquire an impression from 'behind the scenes' *JIQ* spoke with Dutch government official **Mr. Maurits Blanson Henkemans**, who has been involved in the EU talks on the establishment of the EU ETS.

JIQ: Media comments on the ETS allocation process differ. On the one hand, observers argue that the allocation is generally rather flexible so that little reductions below business-as-usual will take place. On the other hand, it is emphasized that the ETS will become the largest emissions trading market in the world and involves governments and private sector entities in climate policies. Which of these views do you support?

Mr. Henkemans: It is obvious that the allocation process is very complicated and politically sensitive. Nevertheless, seventeen countries have already or almost completed this task. However, in my view, this is not even the most important achievement of the allocation process. The allocation of allowances across economic sectors has led to intense debates between the Ministries for the environment and the Ministries of economic affairs in the member states. In many countries this has resulted in a more direct involvement of the Ministries of ecomomic affairs in the climate change debate, which will undoubtedly raise their awareness of the global warming issue and the need to look for sustainable development paths. Moreover, the allocation process directly affects the business community and at least stimulates them to take a more proactive position.

JIQ: Have you noticed differences in the way some sectors have been assigned allowances to?

Mr. Henkemans: Yes, there are differences, because member states use different definitions of 'installation'. In particular, this has had an effect on the allocation in the chemical sector. In the Dutch NAP, for instance, the entire chemical sector falls under the Directive. In the French definition, however, the chemical sector is not covered, whereas in Germany and the UK only a part of chemical sector installations will be covered by the scheme.

JIQ: Do you believe CDM credits will become important during the first ETS period?

Mr. Henkemans: If the European Commission's concern of rather high quantities of allowances in the NAPs is correct, I do not believe that the entities capped by the ETS will develop a large demand for CDM credits. At the same time, and this would be the consequence, the demand for CDM credits from EU country governments may increase. In case of generous allocations, they may face difficulties in meeting their Kyoto targets and so they may need more JI and CDM credits.

JIQ: The allocation for the first period has been primarily based on the method of grandfathering, which seems to give governments a considerable flexibility in sharing the burden across business. What will future allocation processes look like, in your view?

Mr. Henkemans: In order to acquire a level playing field between companies, we should study the possibilities to establish an EU-wide allocation method as of the year 2012. This implies that from then on the EU will decide which sectors will be covered by the ETS and how the allocation will be done, including common definitions and criteria. Consequently, the allocation will be carried out similarly across the EU for all sectors covered. Present differences, which are to a large extent a consequence of the EU burden sharing between member states, would then not exist anymore. Already as of 2006 we should start making an inventory of differences in the way European sectors have been allocated allowances to. By using a CO_2 benchmark approach we could work on harmonising the allocation procedures across Europe. The results of this analysis would be fed into an EU-wide allocation system after 2012.

Whether this EU-wide allocation method would be based on grandfathering or auctioning is still an open question. Should we want to apply an auction system, we would also need a method to channel the funds received from the auctions, back into the ETS sectors. This will open an entirely new discussion.

JIQ:Several observers speculate about linking the EU ETS with those of Canada and Japan. Is that a feasible option, in your view?

Mr. Henkemans: Yes, I think that this is feasible and my impression is that the first link that could be established is the one with Canada. I know that some observers believe that the EU could form a sort of 'mini-Kyoto' should the 'big Kyoto' not go ahead. Personally, I believe that links with other schemes are most likely when the Protocol has entered into force.

JIQ: European Parliament rapporteur Alexander de Roo recently told JIQ that the EU considers bilateral cooperation with some US states. What is your opinion about that?

Mr. Henkemans: Basically, that would be a good idea. We could exchange views and experiences with them and help raising awareness at the state level within the USA. Of course, the states would have to take on absolute, stringent targets. But, again, better after the entry-into-force of 'Kyoto'.

JIQ: Several economists argue that emissions trading reduces the role of the government to a minimum, because the trading can be left to the market. Based on your present experience, would you agree on that?

Mr. Henkemans: The involvement of the government is pretty large. Within the Netherlands government for example, we have had 15 people working on the preparations of the Dutch participation in the EU ETS. Of course, this is not really a surprise when we take into account that we are starting up a system, but also an up-and-running system would require a strong government involvement. The Dutch emissions trading authority (NEA, ed.) will have 15 employees, for instance.

Governments must secure that markets function well. They must do the monitoring and must enforce that all participants comply with their targets. If not, the functioning of the market would be seriously undermined. So, both in the development of the ETS and the application of the system, including monitoring and enforcement, I expect governments to play an active role.

JIQ: The EU have taken the position that the ETS will go ahead, irrespective of whether the Kyoto Protocol will enter into force. Others doubt whether the EU will really be able to do so, should Russia not ratify. What do you think?

Mr. Henkemans: My feeling is that the ETS remains independent of the status of the Kyoto Protocol and so does the link with the CDM. I believe that the positive outcome of the bilateral WTO negotiations between Russia and the EU on 21 May will be important for the Kyoto Protocol. When Russia joins the WTO, this also implies WTO-based restrictions to Russian production processes and requires Russia to take efficiency measures, including a breakdown of energy price subsidies. Such measures directly and indirectly reduce GHG emissions, which would make it easier for Russia to comply with the Kyoto Protocol commitments. So, the positive outcome of Russian WTO talks would be positive for the Kyoto Protocol. That's why president Putin now has promised to start the ratification process.

JIQ: What would you personnally consider to be big or surprising achievements in the entire process of establishing the EU ETS?

Mr. Henkemans: As I said, I am pretty positive about the whole process and what has been achieved so far. In particular, I think it is very positive that we have linked the JI/CDM to the ETS, even though the impact of this may not become that big in the first period. Also, I am pleased that the scope for JI has become larger, because the ETS directive also allows for crediting JI projects that indirectly reduce emissions of installations capped by the ETS. In the former Directive text the credits from such projects could not be added to the ETS allowances as this could lead to double counting. In the current text, a provision has been included that the risk of double counting will be covered through a discount from the total allowances in the member state where the JI project takes place. This is a good incentive for the development of JI projects in the new member states.

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Box. WTO agreement could open door for Kyoto Protocol

On 21 May last, EU Commissioner Pascal Lamy and Russian Economic Development and Trade Minister German Gref signed an agreement in Moscow concluding bilateral negotiations for the accession of the Russian Federation to the WTO. As part of the WTO accession process, which started in 1993 when the Russian Federation applied for WTO membership, the Russian government is negotiating bilateral deals with all interested WTO members. The deal between Lamy and Gref is important, because the EU is Russia's largest trading partner and it constitutes a major step forward to Russian WTO membership. Both sides reached agreement on a number of trade-related issues, including the provision that the Russian government will break down subsidies on gas prices between now and 2010. This basically boils down to almost a doubling of Russian gas prices compared to present levels.

Following the positive conclusion of the EU-Russian bilateral WTO talks, Russian President Putin explicitly linked this success to the ratification process of the Kyoto Protocol: *"The fact that the EU has met us halfway in negotiations on the WTO could not but have helped Moscow's positive attitude to the question of ratifying the Kyoto Protocol."*

See also: Press Release European Commission, IP/04/673, Brussels, 21 May 2004, www.planetark.com at Reuters News Service, 24 May 2004.

State-of-play with the NAPs of the EU ETS

On 31 March and 1 May of this year, the deadline expired for national governments of the EU countries to submit their plans for the allocation of allowances to domestic installations. Not all countries, however, met these deadlines due to extensive domestic consultation procedures and, in some countries, political changes. Up till now Austria, Denmark, Finland, Germany, Ireland, Latvia, Lithuania, Luxembourg, the Netherlands, Slovak Republic, Slovenia, Sweden and the UK (incomplete as installation level allocation still has to be updated) have submitted their final plan. The other eleven Member States have either published a draft version of their national allocation plan, or are in the process of drafting the first version of such a plan (see Table).

Rather high caps

In a press briefing on 18 May last, European Commissioner for the Environment Margot Wallström underscored the key role of the EU emissions trading scheme in the efforts to achieve the EU's Kyoto Protocol obligations. She explained that the Commission had given the Member States that failed to meet the deadlines of 31 March (EU-15) and 1 May (EU-10) a few weeks grace, because: "*the introduction of emissions trading in Europe is a new and initially difficult way of implementing environment policy. Therefore, it is not surprising that almost all Member States had difficulties in meeting the time limits.*"

However, **Ms. Wallström** made clear that she has decided to begin preparations for infringement procedures against EU-15 member states that have not yet submitted their NAP. The reason for such procedures is that too long grace periods would be unfair to those countries that have met the deadlines or submitted NAPs shortly after that. Also, late submissions could create difficulties with meeting the 1 January 2005 starting date of the scheme. Such infringement procedures will not (yet) be prepared for EU-10 countries that have not yet submitted their NAPs, since they had a later deadline (1 May) and could thus still benefit from the grace periods.

In her speech to the media, **Ms. Wallström** expressed concern about the rather high quantity of allowances included in the NAPs. A consequence of rather lenient caps to installations would be that they reduce the scarcity in the market and thus reduce the market price for EU allowances. The Commissioner referred to the significant drop in forward-trade allowance prices from €13 per unit in January 2004 to €7 after the submission and publication of (draft) NAPs. A consequence of low allowance prices would be that little incentives are created within the EU to invest in emissions reductions. **Ms. Wallström** also explained: *"allocating too many allowances implies that an even more substantial effort will have to be taken in sectors not covered by emissions trading."*

Reaction from industry

The first reactions from the industry on the NAPs are somewhat reluctant. The domestic consultation process that followed the publication of the draft NAPs illuminates the complexity of the allocation procedure. Naturally, the industries that are involved in the scheme are looking at their competitive position in Europe. Differences in allocation between countries have led to some protests from the business community. For instance, Corus Group, Europe's third largest steel producer, claims that its CO_2 allocation for the 2005-07 period under the latest draft of the UK NAP is 10 per cent less than it requires. However, there still seems to be room for negotiations as the UK government has stated that it would only finalise its installation level allocation by the end of July.

Sources:
http://europa.eu.int/comm/press_room/index_en.htm
Point Carbon, Carbon Market Europe, 4 April - 23 May 2004

Table. Overview NAP submission to Commission as per 24 May 2004

NAPs submitted to European Commission (in alphabetical order)	*Draft NAPs (i.a.o.)*	*No submission or draft (i.a.o.)*
Austria	Belgium (Flanders)	Cyprus
Denmark	Belgium (Wallonia)	Czech Republic
Estonia	Italy	France
Finland	Portugal	Greece
Germany		Hungary
Ireland		Malta
Latvia		Poland
Lithuania		Spain
Luxembourg		
The Netherlands		
Slovak Republic		
Slovenia		
Sweden		
United Kingdom		
14	4	8

The **Joint Implementation Quarterly** is an independent magazine established to exchange the latest information on the Kyoto mechanisms and emissions trading. *JIQ* is of special interest to policy makers, representatives from business, science and NGOs, and staff of international organizations involved in the operationalization of the Kyoto mechanisms, including emissions trading.

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Abbreviations

AAU	Assigned Amount Unit
AIJ	Activities Implemented Jointly under the pilot phase
Annex A	Kyoto Protocol Annex listing GHGs and sector/source categories
Annex B	Annex to the Kyoto Protocol listing the quantified emission limitation or reduction commitment per Party
Annex I Parties	Countries with a quantitative CO_2 target (OECD, Central and Eastern European Countries, listed in Annex I to the UNFCCC)
Annex II Parties	OECD countries (listed in Annex II to the UNFCCC)
non-Annex I Parties	Countries without a quantified CO_2 target (also non-Annex B)
CDM	Clean Development Mechanism
CDM EB	CDM Executive Board
CEE	Central and Eastern Europe
CER	Certified emission reduction (Article 12 Kyoto Protocol)
COP	Conference of the Parties to the UNFCCC
COP/MOP	COP serving as the Meeting of the Parties to the Kyoto Protocol
ERPA	Emission Reduction Purchase Agreement
ERU	Emission reduction unit (Article 6 Kyoto Protocol)
ERUPT	Emission Reduction Unit Procurement Tender (in the Netherlands)
EU ETS	European Union Emissions Trading Scheme
GHG	Greenhouse Gas
IET	International Emissions Trading
JI	Joint Implementation
KP	Kyoto Protocol
LULUCF	Land Use, Land-Use Change and Forestry
PCF	Prototype Carbon Fund (World Bank)
SBSTA	UNFCCC Subsidiary Body for Scientific and Technological Advice
SBI	UNFCCC Subsidiary Body for Implementation
UNFCCC	UN Framework Convention on Climate Change