THE CHURCH OF ENGLAND

ARCHBISHOPS' COUNCIL

House of Bishops' Europe Panel

Submission by the Church of England's House of Bishops Europe Panel to the European Union Committee Sub Committee D (Environment and Agriculture) Inquiry into the Revision of the EU's Emissions Trading Scheme

1. The House of Bishops' Europe Panel is a sub-committee of the House of Bishops. It acts as a point of reference for items affecting the Church of England's relations with Europe and the European Union institutions.

2. The Europe Bishops' Panel (EBP) welcomes the opportunity to contribute to the Committee's inquiry into the European Commission's proposal for revisions to the EU's Emissions Trading Scheme (ETS). Over the last three years the EBP has devoted a considerable portion of its time to the European Climate Change Programme in general and the proper functioning of the ETS in particular. This interest reflects the seriousness with which the Church takes the threat that climate change poses to the integrity of God's creation, the vocation of humanity to actively steward and care for creation, and the awareness that climate change is already impacting disproportionately on many of the world's poorest communities.

3. Recognising that British climate policy and the global process is largely being shaped in Brussels, not London, the Church appointed in January 2008 a representative to the EU institutions. Based in Brussels this office is responsible for articulating and advocating fresh thinking regarding the EU's progression to a low carbon economy. This submission is reflective of this work.

Executive Summary

4. The EU's ETS, the jewel in the crown in the EU's climate change programme, is the prototype for a global carbon market. It provides a cost effective and economically efficient way of cutting greenhouse gas emissions by enabling reductions to be made wherever they are cheapest. The EU deserves credit for establishing this project, even if its environmental impact to date has been

limited. The ETS remains a project under construction. The Commission's proposals for ETS reform provide a crucial opportunity to learn valuable lessons from its early operation to improve both its simplicity and predictability. The Commission's proposals need to be judged from the perspective of environmental effectiveness and the degree to which a reformed ETS can stimulate the innovation necessary to achieve a low carbon and sustainable economy.

5. The Commission's proposals present a significant advancement on the current arrangement.
   a) We support the decision to restrict the scheme's scope to heavy industrial emitters, rather than widening its remit to include other sectors such as agriculture and surface transport. This should give the scheme greater market cohesion and simplicity.
   b) We hold that replacing national caps with an EU-wide cap comprising Europe-wide sectoral limits distributed to the individual member-states represents a significant breakthrough. It would remove one of the major variables that have contributed to the scheme's volatility.
   c) We favour an automatic transition to 100% auctioning of allowances in 2013, but the proposal to progressively move to full auctioning ensures at least that the 'polluter pays' principle is central to the scheme's operation.
   d) We welcome the proposal to remove current restrictions on the linking of the EU's ETS to other cap-and-trade systems. This opens the way for greater international collaboration, not least with the USA.
   e) We welcome the move to tighten access to the offset market. External credits need to supplement rather than supplant the drive for domestic emission reductions, without undermining the EU's wider international responsibility.

.

6. In a number of areas, however, the proposals are insufficient and more radical reform is needed:
   a) We remain concerned that the EU's reduction targets are not aligned with prevailing scientific evidence. Setting more stringent emission reductions targets now would arguably provide additional incentives for companies to invest in innovative technologies.
   b) We recommend that the future management of the ETS be given to an independent European Carbon Bank. A carbon market is only as effective as the institutions that oversee it. The absence of a strong central and independent authority undermines the scheme's effectiveness.
   c) We agree with the proposed redistribution of auctioning rights on the grounds of economic justice, but we think that the decision to permit some member states to increase emissions in the non-ETS sector is short-sighted both economically and environmentally.
   d) We are concerned that most of the emission reduction within the ETS will be achieve by a one-off shift from coal to gas, rather than by the introduction of new clean technology such as carbon capture and storage (CCS). Further consideration needs to be given to how technological innovation can be funded and commercialised.
   e) We believe that innovative green technology could be commercialised through public–private partnerships using the revenues accrued from the auctioning of allowances under the ETS. The Commission's proposal allows for this possibility but it fails to make sufficient provision for it.

Proposed Level of Emission Reductions

7. The Commission's proposed target of 20% reduction by 2020 is clearly not aligned with scientific evidence. The 2007 Assessment Report by the Intergovernmental Panel on Climate Change (IPCC) argues convincingly that industrialised countries should take on reduction targets of between 25% and 40% below 1990 levels by 2020. To keep the increase in global temperatures in global temperatures below the 2 degree threshold, global emissions need to come down to near zero by the end of the century. This will require industrialised countries, including EU member states, achieving this target by 2050.

8. We are concerned that under existing proposals a significant proportion of the EU's 20% target will be met by emission reduction credits from outside the EU. These credits only cancel out increases in EU emissions; they do not result in a net reduction in global emissions. We are therefore supportive of the position taken by WWF in pressing for an overall greenhouse gas emission target of 30% below 1990 levels by 2020 to be achieved within the boundaries of the EU. Internationally, the EU should invest the financial equivalent of an additional 15% emission reductions in developing countries to assist them decarbonise their economies and adapt to climate change impacts.

The Scope and operation of the EU's-ETS

(i) Scope

9. We welcome the Commission's proposal to extend the coverage of the ETS to the petrochemical, ammonia and aluminium sectors as well as nitrogen oxide emissions from the production of various chemicals. Further consideration needs to be given to the inclusion of methane from active coalmines. We are encouraged, however, that the Commission has restricted the scheme to heavy industrial emitters. These sectors provide well-verified data and clear potential for reductions in emissions, which are essential ingredients for the effective working of any emissions trading scheme.

10. It follows that we agree with the Commission's decision not to include surface transport or shipping within the ETS. Although both sectors generate significant greenhouse gas emissions, emissions that are predicted to rise in coming years, further analysis is required to decide whether the ETS is the most appropriate mechanism to deal with either sector. Reaching a global sector agreement through the International Maritime Organisation would be the most effective mechanism to address shipping. Rising transport emissions is best addressed by other regulatory means, such as by road pricing and by imposing stringent emissions standards for cars.

11. We agree with the decision both to exclude agriculture from the scope of the scheme, as well as those industrial installations currently covered by the scheme that produce relatively low levels of emissions. The agricultural sector comprises a very large number of small businesses whose emissions would be

hard to verify. Monitoring costs would naturally be very high. This would make it difficult to determine the levels of savings achieved. The allocation of a small number of permits to individual farmers would generate insufficient incentive since they would not find it worthwhile to trade them.

(ii) Cap setting.

12. We support the proposal to abandon national caps in favour of an EU-wide cap. This would remove much of the competitive distortions and carbon price volatility that was experienced under Phase 1 of the scheme. Agreeing a linear emission reduction trajectory, setting the cap to 2020 and beyond, which can be automatically adjusted following an international climate change agreement, provides much greater predictability. Delivering an EU central cap set out over 15 years provides a sufficiently long timeframe for businesses to factor the carbon price into their investment decisions. The automatic adjustment to the linear reduction trajectory on the conclusions of the negotiations in Copenhagen 2009 sends a clear signal to the wider world that the EU has the mechanism to deliver on its commitment.

(iii) Technological innovation

13. In light of the recent analysis provided by Deutsche Bank, we are concerned that the emissions targets for the sectors covered by the ETS will to a large extent be met by a one of shift from coal to gas, rather than through investment in low or zero emission technologies such as carbon capture and storage. This raises a number of related problems. A higher dependency on gas carries with it significant geopolitical and economic risks. The projected economic growth in China and India means that competition for gas supplies will become ever more intense with the threat of higher prices. The location of the principal sources of natural gas in many of the most unstable regions of the world means that gas supplies are not necessarily dependable.

14. Analysts predict that CCS could potentially reduce the EU’s carbon dioxide emissions by half by 2050. Further effort therefore needs to be made to commercialise this technology. The Commission's proposal to change the regulatory framework for CCS is helpful, but it will not lead to its adoption on an industrial scale. This will only occur when the price-per-tonne of carbon avoided by use of CCS is lower than the price of carbon. Resolving this issue requires a concerted and coordinated effort at the European level to provide the necessary political and financial support to those CCS projects currently underway in the EU.

(iv)The Practical application and enforceability of the scheme

15. The Commission’s proposals for both simplifying and strengthening the scheme’s compliance and enforcement procedures are crucial to its good functioning, both in terms of achieving the proposed reduction targets but also in potentially linking with third countries. We remain concerned, however, that insufficient attention has been given to the infrastructure required for the scheme’s administration. The Commission’s proposals place far too much emphasis on committee procedure (‘comitology’). This risks allowing key decisions to be subject to intense political and industrial lobbying.

16. We recommend that further consideration be given to the creation of a

European Carbon Bank (ECB). An independent body comprising technical, economic and financial expertise charged with managing the scheme's operation would be preferable to current arrangements. Just as the European Central Bank is mandated with the responsibility for controlling inflation within the Euro-zone, so an ECB could be mandated with taking whatever steps are considered necessary to create and sustain a transparent and efficient carbon market. Detaching the ETS from politicians' electoral cycles would eliminate the dangers of political horse-trading generally associated with 'comitology'. This would provide additional market assurances to business and investors. It is difficult to conceive how current arrangements are sustainable long term when the EU's-ETS is linked with other trading systems.

Allocation and Auctioning

(i) Method of allocation

17. We agree with the Commission's assessment that auctioning of allowances, as the basic principle of allocation, is simple, transparent and efficient. It creates the greatest incentive for investment in a low carbon economy by forcing the market to factor in the cost of carbon. It best complies with the 'polluter pays' principle, and it avoids giving windfall profits to those sectors that have previously passed on the notional cost of allowances to their customers despite receiving them for free. We recommend that unless a pressing and convincing case can be made otherwise, 100% auctioning of allowances should be the norm for all sectors covered by the ETS from 2013 onwards.

18. We are therefore disappointed that the Commission has deviated from its own assessment on the grounds that it is prudent to use the period 2013-20 to phase out the free allocation of allowances so minimising the risk of carbon leakage. Research provided by the Carbon Trust shows that except in a few sectors (steel and cement) the threat of companies moving to countries with less stringent environmental rules is exaggerated. The Carbon Trust estimates that just 1% of EU emissions will be off-shored by 2020 as a result of the ETS. Even if carbon leakage is a possibility, we question whether the free allocation of allowances is an effective counter-mechanism. The Commission's own impact assessment concluded: "Allocating allowances for free does not appear to be an efficient or even effective instrument to remedy impacts on competitiveness".

19. We hold that the more the EU deviates away from 100% auctioning allowances the less transparent and efficient the ETS becomes. It potentially reduces the incentives for investment in a low carbon economy. It also threatens to create new areas of tension between member states as to how allowances to be allocated for free should be distributed. The Commission's proposal to resolve this issue through committee procedure, using a formula combining a top-down approach to determine the total level of free allocation and a bottom up approach to agreed benchmarks lacks clarity. The Commission's proposal risks distorting the market and diluting the 'polluter pays' principle.

20. It is therefore imperative that the Commission's decision to undertake by June 2011 an evidence-based review of sectors that may be at risk from carbon

leakage is independent and resilient to industrial lobbying. We are encouraged, however, by the timing of this review. Securing an international framework agreement on climate change in Copenhagen in 2009 should help address the political concerns that member states have regarding the loss of competitiveness through carbon leakage.

(ii)Redistribution of auctioning rights

21. We support the Commission's proposal allowing for a 10% redistribution of auction permits away from those members states that have an average income-per-head that is more than 20% above the EU average, except where the whole climate and energy package is estimated to exceed 0.7% of GDP. This makes economic sense given the weak economic performance of many newer member states. It is also equitable in that the arrangement takes account of the different levels of development across the member states. The level of redistribution suggested by the Commission would not, however, diminish the pressure on companies based in these countries to lessen their efforts to reduce emissions. In the absence of any reform to the EU's budget, the proposal would provide newer member states with additional auctioning revenue to assist with any structural adjustment programmes.

22. We believe that the redistributive features of the Commission's proposals would carry greater weight if there were harmony across the EU regarding the distribution of emissions caps for the non-ETS sectors. Under current arrangements, poorer member states will be permitted to increase their emission in non-ETS sectors by up to 20% while richer member countries will have to cut their emissions by up to 20%. The analysis provided by Simon Tilford, from the Centre for European Reform, in his May 2008 article, *How to make EU Emissions Trading a Success,* provides a clear warning as to the dangers of such an unfettered approach. Internationally, the EU can hardly expect China and India to place caps on their own emissions, while it is at the same time exempting relatively wealthy countries such as the Czech Republic or Poland from taking similar action. Long term, once the burden-sharing agreement is phased out, such an arrangement risks leaving new member countries at a competitive disadvantage. Again a better solution would be to either use the EU budget more creatively or use the revenues accrued from auctioning to subsidise the costs of energy efficiency measures in poorer member-states.

(iii)Use of auction revenues

23. The Commission proposes that 20% of revenue auctions should be ring fenced for climate related issues. We welcome the decision in principle, but we think that the figure is far too low and needs to be reconsidered. Auctioning revenues should not be used or seen by member state governments as a 'windfall profit'. Rather, they present an opportunity to finance the substantial investments needed in technological responses to climate change within the EU as well a contributing to adaptation and mitigation projects in vulnerable countries in the developing world. We recognise the resistance of some member state governments to imposing legally binding hypothecation at an EU level, but we believe that, in the absence of clearer investment signals from national governments, as well as any progress in reforming the EU budget, the move would be warranted and in keeping with the findings of the Stern Commission.

The International Dimension

(i)Linking with similar schemes around the world

24. We welcome the Commission's proposal to removal of all restrictions on external linking to allow linkage with regional, national or sub-federal systems. Current provisions have enabled the ETS to link with those Annex B countries that have ratified the Kyoto protocol. This has permitted linkage arrangements with Iceland, Norway and Lichtenstein, but these same provisions have handicapped the EU in taking forward negotiations with other third parties. Ideally, the EU's- ETS would only be linked with those systems covered by an international agreement, but the proposals are sufficiently flexible to allow linkage in the absence of such an agreement. The EU should continue to press the USA to sign up to a post-2012 agreement, but the revisions to the ETS directive sensibly provide the opportunity for closer collaboration between the EU and the US regardless.

25. There are clears signs that the US position on climate changing is gradually shifting to an acceptance of the necessity of imposing mandatory cuts on domestic emissions. At a federal level, several climate change bills are currently before Congress, most notably the Jefford-Boxer, Kerry-Snow and the Lieberman-Warner bills. At a state level, both California and New York have passed legislation to reduce GHG emissions by adopting emissions trading schemes similar to the ETS, while ten North-eastern states have formed the Regional Greenhouse Gas Initiative (RGGI). These developments are underpinned by a shift in public opinion about the dangers of climate change and increased frustration from the business community fearful of exclusion from an emerging but lucrative market.

26. The diversity of bills in front of Congress, with their differing scope and application, suggests that whichever model is decided upon, negotiations for a linking agreement will be intensely complicated. There are clear economic, political and environmental benefits in securing a linking agreement, but these benefits could be lost if any arrangement is poorly designed or executed. The decision by the Commission to list ten criteria against which any impact assessment study will be conducted is helpful. The question remains, however, whether the decision to link to another emissions trading system will be taken on political rather than technical grounds, and the degree to which any decision will inspire market confidence while preserving the environmental integrity of the EU's-ETS. We recognise that member states will ultimately want to reserve for themselves the final decision, but we suggest that the responsibility for any impact assessment study should be entrusted to an independent European Carbon Bank rather than being left to the Commission.

(ii) Clean Development Mechanism (CDM)

27. We recognise that the CDM provides a market mechanism by which companies can earn emission credits by investing in developing countries. A 2007 report by Lehman Brothers, *The Business of Climate Change: Challenges and Opportunities*, indicates that by mid-2007 EU member states had committed to investing 7.5 million Euros by 2012 under the CDM and JI.

These investments promise a reduction of more than 2 billion tonnes of carbon dioxide. The CDM therefore provides a source of technological transfer to assist developing countries in introducing cleaner energy.

28. In theory at least it does not matter where the emissions reduction take place as the environmental effect is the same. In practice, however, the primary political purpose of the EU's-ETS is to provide a market mechanism by which the EU meets its emissions targets by decoupling economic growth and emissions. Unless the EU and other developed economies can drastically cut their own emissions it is difficult to see how they can persuade developing economies to stabilise and in time reduce their own emissions. It is self-defeating when a country such as Spain is only able to meet its Kyoto target by extensive use of the CDM and JI. The Commission calculates that in the absence of an international agreement carbon prices within the EU ETS could fall to as low as 4 Euro per tonne if the EU maintained its current stance on imported credits and if there was no successor to Kyoto.

29. It follows therefore that regulating access to the CDM must be done in such a way that it does not undermine the market incentive for companies to invest in new green technologies at home, nor close of developing countries access to clean technologies. The Commission is therefore right to impose stricter controls on the use of imported credits under the CDM, especially in the absence of an international agreement. However, as argued previously, we believe that it would be far more effective to make provision for the reduction targets to be met within the boundary of the EU and for the financial equivalent of an additional 15% emissions reduction to be invested in developing countries to assist them with their adaptation and mitigation efforts.

+Christopher St Albans

The Rt Revd Christopher Herbert
The Bishop of St Albans,
Chair, Church of England's House of Bishops' Europe Panel

Church House,
Great Smith Street,
London,
SWIP 3NZ
United Kingdom

June 2008