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Is Kyoto going? And where?

European Business Reflec- tions

Michael Kohn, Dr.,

Joint Working Party on Climate Change, ICC Paris

Bleicherweg 21, 8002 Zürich

Contact:

e-mail: michelle.roos@awo.ch



A Introduction

In 1997, more than 180 countries gathered in Kyoto, Japan, in search of a coordinated international response to global warming. The agreement was a significant step forward in international cooperation in the field of environment and climate. But the Kyoto Protocol is coming unraveled. Not even Canada, Japan and the European Union - the most enthusiastic advocate of the Kyoto process - are on track to meet their commitments, not to speak of the rest of the world. And whether Kyoto is going and where it is going, is still an open question. No wonder that those concerned with the sustainability of the earth's climate are depressed.

There is a broad discussion about the reasons why Climate Change is not considered of high priority on the international agenda. The world has other problems. People care more about the time and the possible location of a new terrorist attack than about the rise of temperature by 2 to 5 centigrades in the year 2100. A world-wide consensus about the scientific evidence and the anthropogenic aspect of global warming is not yet reached. But the most demotivating fact is the failure of the USA to join the Kyoto process and Russia's persisting indecision to ratify the protocol, thus blocking the treaty from entering into force. These absences and the fact that developing countries have no specific obligations leads to the deplorable fact that only 25% of the world's CO₂-emissions are covered and ruled numerically by the Kyoto regime.

B The European Dispute

As far as Europe is concerned, there are two different positions which evolved from this deadlock: the policy of the EU and the counter-acting attitude of the European economy.

1. Position of the EU

The EU is determined to take the lead in the fight against climate change by reducing its greenhouse gas emissions, with or without Russia, with or without the USA. The Kyoto-Protocol will be observed as if already ratified and in force. (And the Swiss government follows the same direction with the same philosophy "als ob"). Mrs. Margot Wallström in her press briefing in Brussels on May 18, 2004 stressed once more that "dealing with climate change is one of the biggest challenges on the international environmental agenda and therefore on the EU". In other words: the EU will stick faithfully to its commitment. And Mrs. Jennifer Morgan described eloquently in her lecture this morning why an urgent action is needed. And finally even Prime Minister Tony Blair lately warned that climate change could have "catastrophic consequences for the world".

And in spite of these appeals it can be generally observed that the Kyoto process is about to lose momentum. To underline their commitments to the Kyoto Protocol EU Members States took the unanimous decision to establish the European Climate Change Program, whose most signi-



ficant measure for the EU industry is a scheme for GHG emission allowances trading, in short Emission Trading Scheme (ETS). (The EU will impose mandatory caps on CO₂ to a number of industrial installation and build up a market-based system for buying and selling rights to emit carbon). The Trading system will be split up in two phases: 2005 - 2007 and 2008 - 2012. Emission Trading is considered by the European authorities as the most cost effective way of meeting the international target of an 8% reduction. To make the European Emission Trading Scheme (EU ETS) more attractive and efficient, the Kyoto flexible mechanisms, especially the CDM-projects have been linked to the Community scheme by a complementing linking directive.

The launching of a new system, especially in the field of ecology, is a bold undertaking, but the practical implementation is a hurdle-race, especially when economic considerations start to sink in. When Member States started to submit national allocation plans - an important condition in the context of the ETS - the contrast between ecological requirements and economical constraints began to appear. Even Mrs. Wallström had to give voice to her impression "that many of the notified national plans go for a rather high quantity of emission allowances and that many allowances, resulting in low price, would create little incentive to change behaviour". The press lately described the dispute between the environment and the economy ministers of Germany, Messrs. Trittin and Clement, about the size and the allocation of allowances for the industry. Mr. Clement, who favoured a liberal approach, got the upper hand (for the time being).

Not enough, the outgoing EU Energy Commissioner Loyola de Palacio said last week, exactly on September 21, that the EU should rethink the EU ETS if Russia does not ratify the Kyoto Protocol. She expressed fear that Russia finally will not ratify. If that should happen, she recommended to think again on whether to start the EU ETS on its own. De Palacio has commented negatively on the EU's ambitions to tackle climate change unilaterally on several occasions. She fears negative consequences for the European industry (in particular the energy producers and the industrial energy users) if it must take on climate targets that its competitors in North America, Asia and Australia do not have. A spokesman for the Commission replied to de Palacio's comments apparently by saying that "we are convinced that the ETS will start". In other words: economical considerations may flare up, but the ecological duties have priority.

2. Reflections of European Business

Climate change is a global problem which calls for global cooperation. This is necessary from both environmental and economic perspectives. European industry has made a major contribution to combating climate change and is highly mobilised on this objective. However, appropriate framework conditions are necessary so that this contribution is based on the spirit and the rules



of sustainability: ecological, economic and social aspects must be in balance. And even if Russia will ratify the treaty, the rules of Sustainable Development should be observed.

In developing climate policy, the Commission and Member States must take into account that, if all major trading partners are not operating under the same rules which are developed at international level, this is tantamount to imposing a substantial penalty on companies in those countries which are applying these rules, harming their competitiveness and hence their capacity to contribute to social and environmental progress. This is the reason why several business organisations have expressed a lot of reservations on the decision of the EU to go ahead with unilateral measures whether the Kyoto Protocol will be ratified or not. A solo-dancing of the EU would have economic and environmental consequences. Business supports the need to combat climate change. What it is asking for is that the Commission and Member States achieve a right balance between two imperatives, protecting the environment and maintaining the competitiveness of the economy.

Unilateral action by the EU to achieve the Kyoto objectives will only reduce global emissions of greenhouse gases by 1% by 2012 - a tiny step forward. On the other hand the unilateral approach of the EU would have a lot of negative environmental effects: decrease resources available to European enterprises to innovate and to invest in greenhouse gas control technologies; relocation of industry to countries with lower environmental standards and increased need for transport of goods imported to Europe from relocated plants. A continued European "going it alone" policy will also be detrimental in economic terms: reduction of Europe's competitiveness and of its attractiveness to be a place to invest. The cost of the EU implementation of Kyoto is estimated at between 0.15 and 0.30% of European GNP; these estimates must be seen as being at the bottom end of the scale for objective reasons. The Commission on the other side pretends that the effect of the EU policy according to its calculations will only be around 0,1% of GNP. But what cannot be denied is that there is a wide gap between economic growth in the USA, which is around 4% and Europe at 2%. Europe's unilateral Kyoto policy would aggravate this difference. This must be considered in the light of the Lisbon Agenda, when EU Member States solemnly decided to bring the EU's economic power up to the American level till the year 2010.

The leading organisation of European economy is UNICE (Union of Industrial and Employers Confederation of Europe) located in Brussels. It represents more than 16 Million small, medium and large companies. UNICE's members are 36 central industrial and employers federations, economiesuisse included. It has become the speaking advocate of European business.

During the last year UNICE was in close contact with the EU and its Councils. It approached the Competitiveness Council, a consequence of the Lisbon Agenda and the Environmental Council,



without tangible results. In different position papers UNICE drew the attention to the detrimental effect of the present EU policy. Let us select three examples:

- It is an easy way for politicians to regulate the industrial sector. But individual traffic and private housing are major sources of emissions. The EU ETS covers only 45% of the total of Europe's emissions. Therefore, a coherent strategy of reducing greenhouse gas must also focus on stronger contributions from private households (e.g. insulation of buildings), not only from industry. If regulation is needed to reduce CO₂-emissions, all sources must be included in order to distribute the burdens of adaptation.
- This request reminds us that also in the Swiss climate debate the talk is prominently about the sector of automotive fuels (Treibstoffbereich, CO₂-tax or Klimarappen) or of combustion fuels (Brennstoffbereich, fostered by an economic entity like ENAW), but there is no special mention of how to cope with the private and household sectors.
- UNICE also points out that competitiveness of the manufacturing sector will determine to a large extent the level of pay in the private and public sectors and the capital investment budgets of public authorities.
- Another item is the power sector. Energy-intensive industry sectors say they will be doubly penalised under the EU's impending climate emission trading scheme if European electricity pricing mechanisms are not reformed to cope with the system. Trade associations representing the paper, glass, cement, ceramics and ferrous and non-ferrous metals sectors say they could be forced to pay billions annually to the power sector on top of the costs meeting their own trading caps.
- Electricity prices are predicted to rise once the trading scheme begins because producers will have to recoup the costs of reducing emissions from their fossil fuel-powered plants. But under current pricing mechanisms the higher prices will have to be paid for all electricity, even if produced by emission-free nuclear or renewables plants. This will lead to "exorbitant windfall profits" for power companies in areas such as the Nordic states and Germany, at the expense of energy-intensive industries and with no economic or environmental justification. And power costs would come on top of the investment that the industry sectors will need to meet their own emission caps under the trading scheme.

Summarizing its position: Business stands behind climate change, but requests that the economic impact be evaluated.



3. Attempts for a modus vivendi

It is against this background that UNICE has asked the President of the European Council and the President of the Commission to organise a systematic cost-benefit assessment of the competitive impacts of all climate - linked EU policies, considering the assumption that the USA and Russia will not ratify Kyoto. And even if Russia ratifies, an agonising reappraisal of the situation is necessary. At the moment a thorough analysis, neither at cross-European nor at national level, which could provide credible documentation on the (negative) impacts on European economy and business of the present EU policy, does not exist. UNICE urged the European Council to hold a major discussion on the EU's emission reduction strategy at its 2005 Spring session of the Council. It appears that the Commission, reacting positively, has given UNICE and other stakeholders a possibility to contribute to the elaboration of this cost-benefit assessment by submitting their aspirations. It is crucial that UNICE presents its own study documenting the serious consequences to the European economy. Furthermore, to be credible, UNICE and other interested parties will have to investigate whether and where the Kyoto Protocol could be adapted to serve the circumstances. Such adaptations and clarifications would have to gain validity for the period after 2012.

Our gathering to-day is not the place to speculate or invent changes out of the heap. But from my personal point of view I could for example imagine changes in the following direction:

Alternative Method to Allocate Allowances (AMA)

Instead of the actual top-down national approach which derives the allocation of allowances from the Member State target, the novel AAM should be bottom-up, EU-wide, specific to different sectors and based on the concept of continuous improvement of the installations emission intensity (measured in tons of GHG emissions per ton of product), having regard to the status of the technologies in place and setting realistic improvement targets. Absolute targets are thus to be replaced by relative ones.

This alternative allocation method is in fact permitted in the actual ETS. One would only need to change the methodology for the national allocation plans (NAPs). It will not solve all the competitiveness problems, but would go a long way in ensuring:

- a level-playing field for all operators of equivalent installations throughout the EU
- a continuous improvement of the emission intensity of the EU industry
- reward early actions
- allow for flexibility in production to serve domestic and export markets
- achieve the best possible global environmental results for a given production volume, in the actual situation of unilateral commitments.



Other practical examples of relative targets one could consider in this context are:

- Reduction of tons of CO₂ per GDP (this is the target used in the US program)
- Reduction of fuel consumption in cars per 100 km (down from 8 to 10 litres to 4 or 5)
- Reduction of fuel consumption per ton of raw material in the Chemical Industry
- Reduction of fuel consumption per unit kwh electricity, with differentiated reduction rates according to the nature of the power plant, be it carbon, oil, gas or lignite).

Applying sectoral instead of national approaches, replacing absolute targets with relative ones, have the advantage to connect problems and solutions of the same industrial sector with the same kind of installations in various EU member states, allowing benchmarking. This method would allow for growth of the product as long as the input in GHG is kept low.

There are maybe other novelties that could be brought forward to serve climate policy.

There is finally one item that business is watching with ticklish feelings when it observes the European scene. The news goes round that EU authorities, apparently the "Environmental Council", thinks to propose a reduction target of 30% for the period 2012 to 2020. Maybe this is a long shot to be reduced by negotiations. It is known that planning agencies, supported by the Dutch government, are eager to press on the minus 30% target. But even to think of minus 25% or 20% is unrealistic as long as the EU has difficulties to reach minus 8%. The first calculations show that interferences of such magnitude could have an enormous impact on the GDP. Business is against fixing a target for the period after 2012 at this stage. It would be unacceptable that new unrealistic targets are set unilaterally before the cost-benefit study is discussed.

My purpose to bring up this typical example is to show that in the Kyoto process too often the protectors of strict environment try to reach their idealistic goals without appreciating the economic impact of their intentions. Environment and economy have not found yet a common language. It is at least reassuring that the EU Commission has launched a stakeholder consultation (Vernehmlassung) on the EU's contribution to shaping the future global Climate Change Regime. This sounds as if the EU is ready to listen, maybe even to learn. Till now business had the impression that the orthodox representatives of the Kyoto Protocol, in analogy to the defenders of the Bible, were absolutely negative to introduce changes and modernisations out of fear, that by extracting a brick out of the wall, the whole wall could collapse. Better an adapted Protocol than an immobilised Climate Change policy. Nature has no profit when the EU leads a climate change strategy and no one follows.



4. Improving the Kyoto-Protocol

Whatever will be the *modus vivendi* worked out between the EU and the business sector, it will be (at least for the moment) the Kyoto-Protocol forming the basis of the collaboration. It is not ratified, but it exists as a "Leitmotiv".

There are different opinions about the value of the Protocol. Opponents have condemned it as a "deeply flawed agreement that manages to be both economically inefficient and politically impractical" 1). Others think that the Protocol is dead. Christoph Schär, Professor for Atmospheric and Climate Change at the Swiss Federal Institute of Technology (ETH) Zurich and member of the Programme Committee of this meeting says in an interview (with Proclim / Flash), that the Kyoto-Protocol failed (*gescheitert*), but that the Kyoto process (and not the Protocol) will be evaluated as an important milestone in history. There is quite a literature criticising the Protocol and rejecting Kyoto. There are indeed a lot of disagreements and divergences about the Protocol's function.

On the other side it has to be kept in mind that the Protocol constitutes the first international environmental agreement that builds on market-based instruments to determine cost-efficient responses to the undisputed need for GHG abatement. It is clear that a perfect climate policy can only be reached gradually. The Kyoto Protocol is necessarily only one of many possible architectures to address the risks posed by global climate change.

At this moment, whether the Protocol presents a viable and effective way forward is in doubt. Whether or not it does enter into force, the fundamental areas of disagreement must be addressed. This is not the place to discuss and air possible changes and improvements for a generally accepted new Protocol. And it cannot be the idea to renegotiate Kyoto, at least not at this stage. But there is room for interpretation. Already in the context of the present European efforts, some defaults should be taken care of.

The general impression of the Protocol, at least in the business sector, is that it is bureaucratic. The stout supporters of ecology, fully engaged in climate protection, have expressed their devotion in formulating regulations that are often overloaded. Be it the notion of *Supplementarity*, *Liability*, *Compliance*, *Fungibility* or *Flexible Mechanisms*, a lot of red tape is involved. The authors of the treaty, engaged to deliver a proper job, tried to shape the Protocol as perfectly as possible. But perfectionism often lacks clarity.

1) McKibbin and Wilcox 2002, p.107)



Quite a series of uncertainties still surround the Clean Development Mechanism (CDM). A survey, organised in June 2004 by the International Emissions Trading Association (IETA) brought to light that those involved in preparing CDM projects have still questions or reservations about items like the Baseline methodology, the Interpretation of Additionality, the CDM Registry Regulation, the lack of capacity on the local level to develop CDM projects, also about Transaction costs and the Taxing of CERs (Certified Emission Reduction units). A general complaint is the long approval processes.

An insight into the complex procedure to implement a CDM-project is given in the annex (in German language called "Ablauf von CDM-Projekten").

One last default of the Kyoto Protocol that has to be wiped out is the discrimination among categories of CERs. For example, CERs realised through reduced emissions from power plants, whether from substitution by nuclear, hydro, solar or more efficient fossil fuel systems should have an equal value. It is not acceptable that CERs are discarded because they have a nuclear origin. Mr. Blair in his speech of September 14 said that "the government did not rule out the possibility that at some point in the future new nuclear plants might be necessary if we are to meet our carbon targets".

C Global reflections

The Climate Change issue will not be solved by European actions alone. As we know, only 25% of world-wide emissions will be covered. Given the current impasse surrounding the Kyoto approach the question is what new, alternative or additional approaches might be possible and under what umbrella? How do and can the current mechanisms continue if the Kyoto Protocol does not enter into force. What other types of activities could be encouraged?

Whether or not the Kyoto Protocol enters into force, fundamental areas of disagreement exist. They should be addressed and resolved among all Parties as the UNFCCC goes forward. All should participate in a common endeavour to improve and strengthen climate policy implementation under the UNFCCC regime.



In light of the present situation the following questions have to be address:

Should the Kyoto Protocol fail to enter into force:

- How to initiate a global review and reappraisal that would take into account environmental, economic, and social aspects of options for international cooperation;
- How to promote an international framework under the UNFCCC to address climate change, bridging existing frameworks and markets, involving all Parties and their business communities;
- How could such an international framework utilize incentives and other alternatives as an alternative to "targets and timetables?"

Should the Kyoto Protocol enter into force, regarding the period beyond 2012, the questions are:

- Whether and how to pursue a long-term framework that includes future participation by all nations, ensuring global participation
- How to reach participation in emission commitments by developing countries having "common, but differentiated responsibilities". The meaning of "common" is often forgotten.

Speaking of global participation, the inclusion of the USA is at stake. In spite of their absence from the Kyoto Protocol, the Americans are not passive in the field of climate change. The development of innovative and commercially viable technologies, research in the field of CO₂ capture and sequestration and many other efforts are going intensively on. Mr. Brian Flannery has given a picture about ongoing developments in his company and his country. All these activities are of great importance for Europe too. This is the time to stop scolding and avoiding the USA because it has not joined the Kyoto family. In the contrary: common efforts between the EU and the USA should be promoted. There are a lot of common goals, for example:

- Persuade developing countries, especially China and India, to participate in the effort
- Encourage voluntary actions by industry to reduce or avoid GHG emissions;
- Stimulate research and development to create innovative, affordable and reliable, low greenhouse gas technologies and eliminate or reduce regulatory barriers to the development and implementation of new technologies;



- Continue scientific research to better assess risks and opportunities in order to evolve understanding of the nature and size of climate change risks;
- Promoting education programs geared to technological development
- Involve developing countries in science and research and in the practical application of flexible mechanisms to foster capacity building and technology transfer.

There is room for cooperation between Europe and the USA without the Kyoto Protocol being the only linking arrangement.

To summarize: To win the climate change battle has a chance. What is needed is cooperation and dialogue. Business is eager to participate.