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## **CHAIRMAN'S BACKGROUND DOCUMENT N° 1**

**Subject: Objective setting in the context of emissions trading and negotiated agreements.**

### **1. The debate between relative and absolute targets**

Individual Member States have responsibility for determining the balance of the national programmes to deliver their Kyoto targets. They will need to consider a range of factors when determining the shape of the programme, including business competitiveness, political acceptability, practicality, and the availability of measures agreed at the EU level. Within this context, there is likely to be a role for a number of different types of policy – including taxation, regulation, negotiated agreements and emissions trading – some of which will operate at Member State level and some of which will operate at EU level. It will be important to achieve consistency and complementarity between these different approaches. One specific issue is the relationship between negotiated agreements – many of which have already been agreed by Member States in terms of achieving energy efficiency improvements – and emissions trading – the currency of which is tonnes of carbon dioxide equivalent. This relationship is addressed in this document. Particular attention is paid to the impacts on competitiveness and the implications for the structure of the trading market.

### **Part 1: the assumption of responsibility for meeting Kyoto commitments**

- 1.1 Objective setting should be the subject of negotiation and agreement between government and interested parties.
- 1.2 It is necessary for policy makers to establish how much emissions trading and negotiated agreements will contribute to overall emission reductions. A further decision has to be made on the contributions expected from negotiated agreements based on relative (or “product performance standard”) targets, and those based on absolute targets. Most negotiated agreements agreed up to now have been based on relative targets. An example would be the agreements undertaken by ECMA (more widely known as “ACEA”), JAMA and KAMA.
- 1.3 Using expectations of economic growth and output increases, it is possible to project in absolute terms the likely contribution in terms of emissions reduced in a given period (subject, of course, to the uncertainties of the assumptions made). The major difference between relative and absolute targets from the perspective

of the policy-maker is that the latter provide much greater *ex-ante* certainty about the level of emission reductions to be delivered. The flexibility which relative targets may offer to expanding industries or those in energy-intensive export-competitive sectors needs to be balanced against the more stringent targets which may have to be imposed on the rest of the economy if the output of these industries is underestimated.

- 1.4 The Kyoto Protocol's targets for Annex B countries are absolute. They are not related to economic growth between 1990 and 2008-2012. A much greater effort is required of practically all Annex B Parties than is represented by their percentage reduction figures as laid down in Annex B of the Protocol. For the case of the European Union, an 8% reduction compared to 1990 represents, on the basis of present forecasts (and existing policies), an actual need to reduce emissions by some 13% compared to where they would be taking account of economic growth in the meantime<sup>1</sup>. These estimations are, of course, open to the uncertainties of economic forecasting.
- 1.5 In determining the shape of their national programmes to deliver the Kyoto targets, Member States will almost certainly see a role for a range of measures and approaches. In particular, if Member States are prepared to impose additional policies and measures or to acquire more in the context of the Kyoto mechanisms in the event that emissions from a given sector turned out to be higher than forecast, then relative targets for industry could still play a significant role in climate change abatement policies. Indeed, Governments will accept this possibility in respect of non-trading policies and measures, whose precise environmental impact is uncertain, and whose impacts are partly related to economic growth.
- 1.6 The consequence for the relative targets that have been and are being negotiated is that the performance standards must be stringent enough to ensure that – when allowing for growth in output – Member States will still be able to deliver their overall absolute emissions reductions. The same caveat applies to all measures that do not guarantee absolute emissions reductions. It should also be noted that where the improvements in energy efficiency are proportionately greater than any increase in output, relative targets will in any case deliver absolute emissions reductions. In industries when output is declining over time, relative targets may well prove more difficult to achieve.
- 1.7 From a methodological point of view, both relative and absolute targets will be set in the context of an implicit or explicit assessment of output growth. But where targets are set in relative terms, if the assessment of output growth too low policy-makers must take additional measures. With absolute targets, the responsibility lies with industry. This does not, of itself, make negotiated agreements based on relative targets any less worthy than absolute targets, but it

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<sup>1</sup> Two studies giving the economic consequences of an EU-wide greenhouse gas trading scheme are now available at: <http://europa.eu.int/comm/environment/enveco/studies2.htm#13>

These studies provided the economic input to the "Green Paper on greenhouse gas emissions trading within the European Union" ([http://europa.eu.int/comm/environment/docum/0087\\_en.htm](http://europa.eu.int/comm/environment/docum/0087_en.htm)) which was adopted by the European Commission on 8 March 2000 and which interested parties are invited to comment on before 15 September 2000.

underlines the importance of fixing the right relative target where relative targets are fixed, and in understanding the sharing of emission reductions involved.

## **Part 2: maintaining compatibility with the Kyoto mechanisms**

- 1.8 There is another important point when comparing the merits of relative or absolute targets. Industry and the Commission wish to remain compatible with the Kyoto Protocol's emissions trading, which will be denominated in metric tonnes of CO<sub>2</sub>-equivalent. Absolute targets can be similarly denominated, and so compatibility is more easily demonstrated. But relative targets defined in quantities of carbon (or CO<sub>2</sub>-equivalent) per unit of output is a different denomination that can only be compared with tonnes of CO<sub>2</sub>-equivalent reduced through the use of an agreed and transparent conversion formula. However, there is an additional burden in respect of monitoring, reporting and verification. It may still be possible to allow trading to take place in the context of relative targets, among the sectors that have accepted such targets. This would require an *ex post* assessment of output, which can then be used to establish the under- or over-achievement of the relative targets, converting them into absolute units. Companies can then be credited with permits if they have over-achieved their target, or required to purchase allowances if they have under-achieved. This is, in effect, a "baseline and credit" approach to emissions trading, and can be compatible with emissions trading under the Kyoto Protocol.
- 1.9 It would also be possible to design a trading system in which companies with relative targets would be allowed to participate in emissions trading as sellers outside the sectors covered by the relative targets. However, there would have to be two constraints on such sales. The first is that the sector as a whole accepts an absolute cap on its emissions (adjusted for net sales or purchases by companies covered by the sectoral cap). The second is that transfers outside the sector would have to wait until there was certainty whether or not (and by how much) the absolute target was achieved<sup>2</sup>.
- 1.10 In the longer term, even industries who prefer relative targets may see the attractions of the simplicity, that industry says it wants, of a classic "cap-and-trade" programme.
- 1.11 There are two choices facing policy-makers: relative or absolute targets, and negotiated or mandatory agreements. Relative targets transfer the risk of output fluctuations from those sectors of industry covered by them to the rest of the economy. Furthermore, they make trading more difficult and less transparent. "Negotiated agreements" in general have "softer" compliance sanctions, that industry prefers, but mandatory agreements give greater certainty to policy-makers and participants alike. Emissions trading, whether established by agreement or by mandatory action, must have stricter sanctions to provide conditions under which a market will operate. Sectoral, rather than site-specific, "negotiated agreements" may have some scope for flexibility within the sector, but such flexibility would have to be regulated within the sector if over-achievers

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<sup>2</sup> This would not prevent "forward" sales being made earlier, but these would have to be made conditionally until fulfilment of the necessary conditions for transfers to be actually carried out.

are to be compensated by under-achievers. Unless the sectoral regulation is able to provide that certainty, then the sectoral agreement is less likely to be respected, and so less likely to be continued in future.

- 1.12 If it is accepted that any sectors may increase their overall emissions, such as may happen in the case of negotiated agreements with relative targets, then a correspondingly greater effort will be necessary from the remaining sources and sectors. It is, therefore, of considerable importance to *all actors* that the level at which negotiated agreements and emissions trading objectives (whether absolute or relative) are set for certain actors are appropriate, given that the remaining sectors will have to make up the difference if the commitments of the Kyoto Protocol are to be respected. Governments could also decide to cover any “missing tonnes” through the purchase of permits from abroad.

### **Part 3: Conclusions**

- 1.13 It is possible that relative targets can be made to be as demanding as absolute targets, depending on the level at which they are set. However, to be made compatible with emissions trading under the Kyoto Protocol, relative targets will have to be converted into the number of tonnes reduced in absolute terms (if any). Such conversion can only be done with certainty *ex-post*, once output is known. Consequently, any such transfers of allowances can only take place at the end of the commitment period. With absolute targets denominated in tonnes of CO<sub>2</sub>-equivalent, on the other hand, direct compatibility with the Kyoto mechanisms would be ensured.
- 1.14 The issue of responsibility is at the heart of the debate about absolute and relative targets. Industry wants compatibility with the Kyoto mechanisms so that it can have access to the Protocol’s international markets. However, if Governments believe that compatibility is undermined by the nature of the targets agreed, then private sector access to these international markets may be restricted to actors who assume the responsibility for meeting the absolute emissions targets. However, the Protocol explicitly allows private sector involvement in Joint Implementation and Clean Development Mechanism projects.