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A permit to print money

Far from incentivising emissions cuts, the EU's carbon trading scheme provides a grotesque subsidy for the biggest polluters

Oliver Tickell
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There is a "magical logic" in the way hundreds of billions of pounds' worth of carbon allowances are given away to polluting companies, an employee of an major UK carmaker told the Guardian. That company, as David Adam reveals, was given twice as many allowances – tradable pollution permits created by the EU's Emission Trading System (EUETS) – as it actually needs to cover its own emissions. The remainder it will sell in the UK's dynamic carbon market, receiving a multimillion-pound windfall profit.

This is strange. Under the "polluter pays" principle, a longstanding cornerstone of the UK's environmental policy, polluters are meant to pay for the cost of their pollution – that is, for the damage that their pollution causes to others (for example, in harming health or damaging property). For carbon dioxide, the main pollutant responsible for global warming, Nicholas Stern argued in his famous Review that every tonne of CO2 emitted to the atmosphere imposes damage worth $25 to $85 per tonne on society as a whole. It follows that this cost should be paid by the companies responsible.

But in the looking-glass world of the EUETS, the "polluters pays" principle is replaced by its mirror image – the "polluters get paid" principle. This is very magical indeed for the companies that benefit, and for their shareholders. As for the logic ... well, who needs logic when there is money to fill your boots with, and serious money at that? As we struggle to stay afloat amid rising fuel and food costs, the falling pound and a collapsing property market, there is at least one thing we can be glad of: the carbon market is booming. Between 2006 and 2007, the market for EUETS allowances grew 104%, turning over an astonishing $50bn (pdf).

Carbon fortunes are indeed being made, and many of them in the City of London, which dominates the global carbon marketplace. But the biggest winners of all are the biggest polluters, the power companies, which benefit to the tune of €30bn per year. According to energy regulator Ofgem, the UK's power companies will receive a £9bn windfall profit from their free allowances between 2008 and 2012. And now a broader range of industrial companies are cashing in on the carbon bonanza.

The problem arises from the very structure of the EUETS. When it was set up in 2005, each country was given its own allocation of allowances, and they passed on the allowances to the biggest industrial polluters based on their historic greenhouse gas emissions – the more they had been polluting, the more allowances they were given – in a process known as "grandfathering". And companies are still being given allowances based on those same historic levels of pollution, even if they have reduced their emissions since then.

There is one sense in which this is fair enough: companies that have become more efficient deserve their reward. After all, this is why they invested in efficiency in the first place. But this is not quite as fair as it looks. It means that companies that had already raised their energy efficiency *before* the EUETS came into being are being penalised. Those that deliberately bloated their carbon emissions, which they can now bring down easily at little cost, are getting the biggest reward. Moreover, the system effectively bars new players in any industry that would have to buy all their allowances – creating unshakeable established monopolies.

More fundamentally, we must recognise that the EUETS allowances are a form of money – tradable instruments like, for example, government bonds issued by the Treasury. We would not be very impressed by a chancellor who gave away billions of pounds' worth of government bonds to banks. We should be equally unimpressed with the EUETS as it gives away 2bn carbon allowances a year, worth – at today's price of €23.35 – €47bn.

There is an alternative. At the inception of the EUETS, every economist in town was imploring the EU to sell the carbon allowances by auction, up to the emissions cap, to avoid all the entirely predictable consequences of grandfathering. This way, the polluters would be competing to buy their allowances, and their would come back to the public purse where it could be used either to reduce the level of taxation generally, or to finance projects to reduce emissions - investing in energy conservation, for example, or renewable energy. But under pressure from industry lobbyists, the EU caved in. Amazingly, the EU's rules even prohibited individual countries from auctioning their allowances, just in case they wanted to.

Since then, there have been reforms. Under Phase 2 of the EUETS, which runs from 2008 to 2012, countries are allowed to auction their allowances, up to a limit of 10%. The percentage will go up in Phase 3 (2013 to 2020) to 60%, but we will probably have to wait until 2021 for 100% auctioning – if we're lucky. And by then, the public purse will have been sold out to the tune of €500bn or more.

Say what you might about Brussels lobbyists, they are worth their weight in gold – at least, to the companies who pay them. In this particular case, about 1bn troy ounces, or 30,000 tonnes of the stuff. Now, there's magical logic for you. Midas, eat your heart out!