HMRC - VATSC64220 - Compliance Market

The Kyoto Protocol

The Protocol came into force on 15 February 2005 and requires developed countries, which have ratified the agreement, to limit their greenhouse gas (GHG) emissions over the period 2008 to 2012 (‘the first period’). It puts in place a ‘cap and trade’ mechanism for GHG emissions.

Kyoto imposes an emissions target on developed countries, expressed in tonnes of carbon dioxide emissions. Each country receives Assigned Amount Units (AAUs) equivalent to their target emissions for the first period. One AAU is equivalent to one tonne of carbon dioxide emissions.

Under the Protocol, countries must have sufficient allowances to cover their actual GHG emissions or they will be subject to penalties. The EU as a whole has committed to an 8% reduction in GHG emissions over the period 2008 to 2012, compared to 1990 levels. The UK’s share of that target is a reduction of 12.5% over the same period.

Developed countries can meet their emissions targets through a combination of domestic climate change activities and the use of three Kyoto mechanisms

Joint Implementation (JI)

Clean Development Mechanism (CDM), and

International Emissions trading (IET)

Both JI and CDM are ‘project based mechanisms’ and involve participation in climate change projects overseas. The carbon credits resulting from the projects can then be ‘repatriated’ and used by project investors to meet their own Kyoto targets or sold on.

The CDM allows ‘developed’ countries to meet their emissions reduction targets by generating credits from emissions-reducing or saving projects in developing countries. This allows for the reduction to be made at lower cost than might otherwise be possible domestically. CDM projects are subject to stringent certification procedures and must satisfy a set of criteria, the two most critical being ‘additionality’ (the principle that emission reductions achieved must be additional to those that would otherwise occur) and sustainability. The carbon credits that accrue under CDM are termed Certified Emission Reductions (CERs) and are issued by an international body called the CDM Executive Board. One CER is equivalent to one tonne of carbon dioxide emissions.

A JI project is one which is undertaken in another developed country. The emission reduction credits accruing under the project are issued by the host government and are termed Emission Reduction Units (ERUs). One ERU is equivalent to one tonne of carbon dioxide emissions.

IET is the trading of emissions reduction credits. Under IET a country, which has less allowance units than its actual emissions, can purchase credits on the international carbon market to overcome its shortfall and thus comply with its Kyoto commitment. A country which has more allowance units than it needs can sell its excess in the market.

The EU Emissions Trading System

The EU Emissions Trading System (EUETS) is an EU scheme which derives directly from Kyoto and is intended to help the EU meet its Kyoto commitment. Like Kyoto, the EUETS is a market-based, ‘cap and trade’ scheme and is designed to provide incentives to polluting businesses to reduce their carbon emissions (and so contribute to the meeting of national GHG emissions targets).

Under the EUETS specified ‘installations’ (listed in Schedule 1 of the UK regulations and including energy, and iron and steel producers) are required to hold a GHG emissions permit. Holders of permits are allocated EU Allowances (EUAs).

At the end of each year installations must ensure that they have enough allowances to account for their installation’s actual emissions. If they have exceeded their allocation, then they need to buy additional carbon allowances or face penalties for the shortfall. In addition to buying EUAs to meet a shortfall, participants may also purchase (within certain limits) CERs from the Clean Development Mechanism or ERUs under Joint Implementation. If they have excess EUAs they can sell these in the carbon market.

The UN Framework Convention on Climate Change (UNFCCC) lays down standards for calculating emissions. Both Kyoto and the EUETS, and their resulting carbon credits or allowances, are regulated by national and international bodies. Under Kyoto and the EUETS, compliance market carbon credits are recorded in a registry and are ‘retired’ once they have been used to offset emissions.

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