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Q&A: The European emissions trading scheme

What the ETS is and why it doesn't work, yet

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What is the European emissions trading scheme (ETS)?

The world's first large-scale carbon trading market, set up in 2005 under the Kyoto protocol as a way to use the market to reduce industry pollution.

How is it supposed to work?

Hundreds of polluting companies, including power generators, oil producers and car-makers, have their direct emissions from fuel use capped by the European commission. Companies that produce more pollution than allowed must buy permits from cleaner rivals. In time, the cap is reduced and the price of carbon permits rises to the point where firms would rather invest in reducing their emissions.

Does it work?

Not yet. The first phase of the scheme, from 2005 to 2007, is widely viewed as a disaster. European governments gave out too many permits to their companies, which then put them up for sale. The result? The price crashed to €0.1 in September 2007. There was also criticism of the windfall received by electricity generators. These were the only companies to be given fewer permits than they required, but were allowed to pass on the cost to their customers.

What do the new figures revealed by the Guardian show?

They refer to phase two of the scheme, which begins this year but is overdue. They show that as many as 200 UK companies (outside the electricity supply sector) have received too many permits again.

Why does it matter?

Because the UK permits are given out for free, but have an asset value, the companies with too many have effectively been handed a subsidy. The over-allocation could also send out the wrong message. About half the EU carbon dioxide emissions are captured in the ETS, but governments have so far been reluctant to tighten the cap to squeeze the firms to reduce emissions. Most in the UK have effectively been given official permission not to reduce pollution for the next five years.

What next?

Companies can bank spare permits for use in the third phase after 2012, when their value is expected to rise, so the price should not crash again. How permits are allocated in phase three, currently being decided in Brussels, could make or break the success of the scheme. Campaigners want Brussels to auction the permits. Industry lobbyists are trying to maintain the current free-for-all.

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