sandbag

Campaigning for an effective carbon market

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Response to the public consultation on the EU ETS backloading proposal

The ETS has successfully imposed legal limits on emissions of carbon from over 11,000 installations across 27 member states however it is in urgent need of structural supply-side reforms to correct for the overhang of EU allowances left after the combined effect of over-allocation and recession and to make the scheme more resilient in the future. As a prelude to these structural reforms we welcome the proposal to backload allowances from the start of Phase 3. It is imperative, however, that this temporary withdrawal of allowances act as a prelude to their permanent cancellation later in the phase and that the quantity of allowances withheld is proportional to the scale of the supply side crisis facing the scheme. Our research, set out in our latest annual report[1] on the ETS, supports removing 2.2 billion allowances from Phase 3 to restore the levels of scarcity envisaged at the time that budget was set.

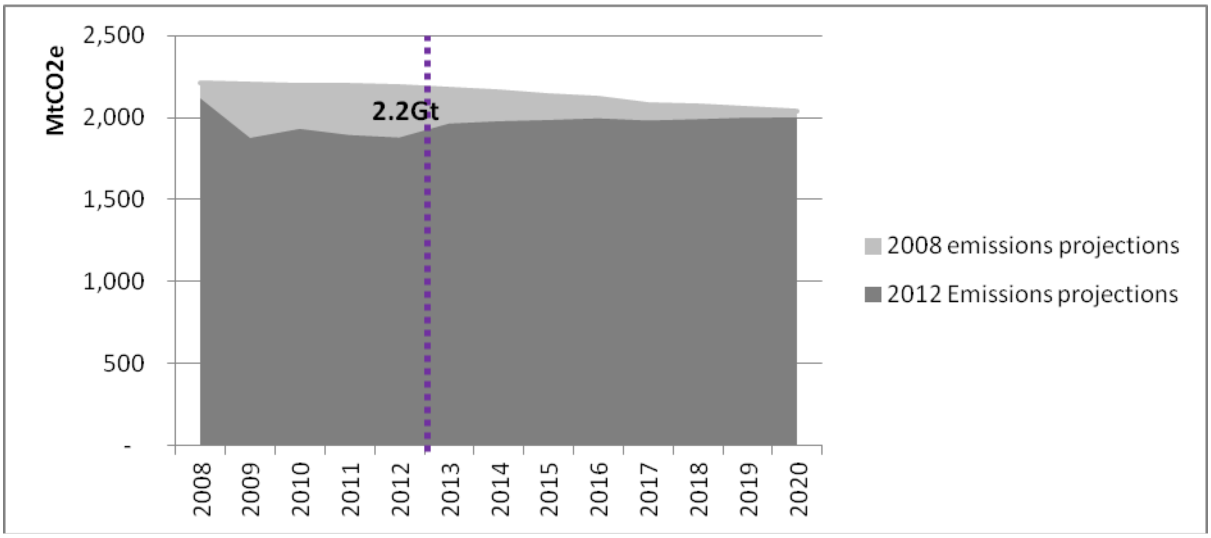
The stated aim of the EU Emissions Trading Scheme (ETS) is "to promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner."[2] An implied secondary objective is to drive investment into low-carbon and energy-efficient technologies in Europe.[3] The EU ETS urgently needs reform because it is failing to meet both objectives, but the reforms need to be commensurate with the profound problems the EU ETS currently faces.

Demand for ETS allowances has been drastically lower than expected owing to the effects of the financial crisis, the sovereign debt crisis and conflict with other climate and energy policies. This has considerably lowered the price of carbon, which is now too low to drive investment in low-carbon technology and infrastructure or indeed fuel switching – the lowest cost abatement option in Europe. The resulting "carbon lock in" threatens to make it far more expensive to reach Europe's 2050 climate goals[4] as assets become stranded or the range of mitigation options narrows.

Sandbag reviewed analysts' baseline emissions projections for the traded sector in 2008, and compared this against their updated predictions in 2012 as well as the historical emissions for the years in between. We found that, back when the Phase 3 caps were set, analysts expected 2.2 billion tonnes more CO_2 to be emitted out to 2020 than they expect today. Assuming that policymakers had similar expectations when they established the caps, they did not intend Phase 3 to start with a legacy of banked EUAs equivalent to one years worth of emissions, they would have expected the offset budget to be largely exhausted, and they would have expected Phase 3 baseline emissions to be much higher than we now anticipate.

[1] Please see our report *Losing the Lead?* for more detail http://www.sandbag.org.uk/site_media/pdfs/reports/Losing_the_lead_modified_3.8.2012.pdf
[2] Article 1 of the Consolidated EU ETS Directive 2003/87/EC
[3] Recital 20 of the Consolidated EU ETS Directive 2003/87/EC
[4] The EU has set a goal of achieving 80-95% emission reductions by 2050 compared with 1990 levels.

Figure 1: The changed ETS emissions outlook since 2008



To restore the scarcity of allowances originally intended when the Phase 3 caps were set, we therefore recommend that ~2.2 billion tonnes of allowances be removed from the auction and then permanently removed from the phase.

Withholding a smaller quantity of allowances will, at best, serve to even out the supply and price in the next few years, while leaving the fundamental oversupply of allowances in the market unaffected. Reducing the short-term volatility of the price in the scheme is, however, trivial when that price signal is too low to drive even the cheapest known forms of abatement (e.g. fuel switching). What is more, even the weak current price is likely to be supported by the market's expectation that policymakers might yet make permanent structural adjustments to the scheme that reduce the supply of allowances.[5] That confidence will wane if a weak back-loading proposal is approved, potentially cancelling out any price-rally expected from the backloading itself.

It is preferable then, that a significant volume of allowances is removed now. This will increase the confidence of the market that a permanent withdrawal of allowances will eventually follow, and reduce the likelihood that policymakers will need to make repeated interventions to remove allowances later in Phase 3.

The legitimacy of backloading

The Commission has already changed the auction regulations twice to enable changes to the timings of auction without the need for a clarification to the text of the Directive. The auction regulations were first changed to allow 300 million allowances from the Phase 3 New Entrants Reserve to be sold over 2012 and 2013 and were changed again to bring 120 million Phase 3 allowances forward for the purposes of hedging by the electricity sector.

It seems unusual that the Commission should now be required to pursue further clarification to the Directive when it seeks to backload allowances, but did not require this when allowances were frontloaded. We would not, therefore, have thought that a proposal to change the language in the ETS Directive would have been necessary. But now that this process has begun, we hope that it can be concluded smoothly and efficiently so that the backloading can rapidly get underway.

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5 This issue was highlighted in Deutsche Bank's report 'What is the value of a political option' (November 2011) which said: "we think the value of an EUA now lies exclusively in the optionality it gives on EU policymakers at some point amending current EU-ETS targets and/or legislation with a view to engineering higher prices". In that report Deutsche Bank's price valuation of EUAs at €10-12 out to 2020 was a middle estimate between a scenario with intervention (with EUA prices rising to €20-25) vs. one without (where EUA prices languished around €7).

Some notes on liquidity

The Staff Working Document accompanying the backloading seems to recommends preserving a buffer of allowances in the scheme in order to maintain liquidity in the scheme and prevent price volatility.

"A certain level of such a buffer promotes the proper functioning of the market by producing a more stable price signal. Without a buffer the market cannot absorb annual variations in market fundamentals affecting demand and supply and may therefore be prone to a more volatile pricing pattern."[6]

We find this argument to preserve a buffer of surplus allowances highly troubling in relation to a policy designed to engineer a scarcity of supply against business-as-usual emissions. The current surplus has not been achieved through investment in low-carbon technology, but arrives through a change in baseline emissions owing to background economic conditions combined with generous access to offsetting credits. There are already measures in place to guarantee liquidity including the allocation of free allowances for the coming year before the previous year's compliance deadline and continued access to offsets. Liquidity concerns should therefore be no barrier to restoring the envisaged levels of scarcity to the scheme.

That said, as we wait to see if the political will exists to cancel any allowances provisionally backloaded, we should avoid creating any sudden bottlenecks that would unnecessarily raise the costs of compliance to some installations. If 2.2 billion allowances were held back, we would recommend this was stretched across the first <u>four</u> years of the Phase as a minimum and preferably stretched across the whole eight years if allowances can legally be backloaded to future trading phases.

Recommendations

- **We call for the European Commission to publish both its original and revised analysis of the baseline emissions in the traded sector, and the level of abatement the ETS was expected, and is now expected, to deliver against this.**

- **We call on the European Commission to withhold allowances equivalent to the absolute difference between 2008-2020 BAU emissions as projected in the 2008 impact assessment and 2008-2020 BAU emissions as expected today. We provisionally calculate this at 2.2 billion allowances.**

- **Any backloading of Phase 3 allowances should anticipate their cancellation as part of a package of a wider package of structural reforms to ensure appropriate ambition and maintain incentives within the scheme.**

[6] Page 17, http://ec.europa.eu/clima/policies/ets/auctioning/third/docs/swd_2012_234_en.pdf