

## Comments on Structural Options to Strengthen ETS

CO2 Spain appreciates this opportunity to comment on structural reforms to the EU ETS.

### *Part but not all of the surplus is due to the economic downturn*

The phase II cap is almost identical to that originally calculated by the Commission (comparing SWD(2012) 234 final with the cap of 2,063 Mt/y in COM(2005) 703 final). That original cap assumed a growth rate of 2.5% annually through 2010, although real EU27 growth from 2003 to 2010 was 1.4% (Eurostat).

The difference between projected and real growth is 1.1%. This is very significant compared to the phase III linear target of 1.74%. The difference between real and projected growth has produced an over-allocation that can be calculated to be some 800 Mt over the past 5 years. Therefore, about half of the EUA surplus can be attributed to this difference.

The macroeconomic scenario used by the Commission was based on EU Energy Trends to 2030. The most recent update of that document now has a long-term forecast growth of 1.7% up to 2030. Many individuals and organizations commenting on ETS structural reform expect to see even higher growth, at least during some future years.

### *The surplus from the downturn should be reserved for future growth periods*

Some 800M excess phase II EUAs were issued due to the difference in projected versus real growth rates. In the future, deviation between real and projected growth will occur: both positive and negative deviations. Furthermore, the verified emissions dataset corroborates that ETS sectors are highly sensitive to such variations.

Some market observers argue that nothing should be done for this part of the surplus. Their theoretical arguments that the market is responding correctly are impeccable. Nevertheless, when deviations between projected and real growth (either positive or negative) are nearly identical to the annual linear emission reduction target, the impact on price volatility is very large. Unbridled price volatility is a hindrance to investment in low-carbon technologies. Article 29a of the Directive impedes a strictly laissez faire treatment of EUA price volatility on the upside. Therefore, an analogous consideration for the downside appears warranted based on regulatory precedent and market performance.

The most coherent solution for this part of the surplus would be to establish a formal reserve. The initial reserve would receive up to 800M phase III EUAs to compensate for this part of the surplus from phase II. These EUAs are not retired (option b), but rather, set aside for future needs.

EUAs from the reserve could be auctioned during years when growth exceeds 1.7%; additional EUAs could be added to the reserve during years when growth is less than the projected threshold. Such a reserve should operate under strict quantity / deviation rules, and not be a price monitoring mechanism (option f).

### ***Phase I over-allocation has propagated into Phase II and even Phase III***

Although the Commission Decisions on phase II NAPs included greater precision and updated assumptions compared to the initial guidelines (COM(2005) 703 final), the overall phase II cap calculated in 2005 has been adopted de facto by the Commission. Unfortunately, it was based on 2005 allocations, not emissions. These phase I allocations were later proven to be excessive, but in essence and by mathematical formulas, were grandfathered into phase II.

Furthermore, the first paragraph of article 9 of the Directive requires that the phase III cap be calculated from phase II allocation (not emissions). Therefore, the 2005 over-allocation that was grandfathered into phase II gets further perpetuated into phase III and beyond.

Due to the strict timing requirements for the phase II NAPs, it was not possible to fully utilize the verified emission dataset. Very soon, the complete phase II verified emissions data will be available.

The structural change to address this spurious “cap math” would be to use real, verified emissions instead of grandfathered over-allocations to calculate the cap, thus implying a modification to article 9 of the Directive. This proposed structural change does not modify the linear factor (option b), but rather changes the baseline to which the factor is applied.

### ***Consider all unit types to be surrendered in setting the cap***

Due to the development pace of the CDM and the collapse of phase I EUA prices, international credits have only come into play during phase II. The phase II allocation considered international credits as a volume-based “safety valve”, i.e., above and beyond the EUA allocations. Nevertheless, phase II EUA issuance exceeds phase II verified emissions. International credits thus exacerbate the surplus.

If the use of international credits is supposed to reduce compliance cost, then the cap should be reduced by the amount of international credits allowed. If their use is not considered in the cap, then a permanent surplus could occur in the ETS.

What is a reasonable balance between a volume-based “safety valve” and a price-oriented measure to optimize compliance cost? Phase II experience suggests that not considering the use of credits in the cap might be imprudent. As a first structural measure, one could contemplate reducing the cap by 50% of the allowed use of credits. For example, if the average allowed use of credits is 5% of verified emissions, then the cap could be adjusted downward by half that amount, some 2.5%.

This proposal does not limit the use of credits (option e), but rather modifies that cap of EUAs considering their use. Since the suggestion of 50% is rather arbitrary, it would be subject to future review by the Commission.

### ***This half of the surplus - due to spurious “cap math” - should be retired***

As argued above, the part of the surplus due to lower than expected growth should not be retired, but rather, set aside in a reserve to respond to future positive deviations between projected and real growth. The remaining surplus, as analyzed above, can be ascribed to limitations in the available data and methods to calculate the phase II cap. Structural measures can be applied so these errors do not propagate into the future. Nevertheless, the structural measures suggested above do not address the surplus already generated.

The appropriate solution for this second half of the surplus is option b: permanent retirement.

### ***Interaction between the quantitative and qualitative limits for international credits***

Another fundamental change during 2012 that deserves structural review is the interaction between the ETS limits for international credits. ETS has two limits on their use:

Quantitative: to ensure their use is supplementary

Qualitative: originally to ensure environmental integrity, and more recently to also support Europe's international negotiation stance

ETS operators must abide by both limits. Pricing in the carbon market, however, utilizes only the more stringent of the two.

Up until 2011, the market assigned prices to ETS-eligible CERs based on the qualitative limit. The quantitative limit appeared to be a long-term issue, considering the lengthy and risky CDM approval process, so the market considered the potential demand for ETS-eligible CERs to be almost infinite.

During 2012, market perception of the two limits changed. Today, the market views the qualitative limit to be irrelevant, since ETS compliant CERs are expected to outnumber demand. The quantitative limit is now the more restrictive of the two. CER prices thus decoupled from the EUA and got pegged to AAUs and other surplus Kyoto units.

The structural reforms considered by the Commission would clearly "fix" the EUA market. Europe cannot fix the oversupply in the Kyoto market, but it can ensure that the two ETS limitations for the use of international credits in ETS are properly aligned. It is necessary to address this structural issue if the goals behind the qualitative limit are to be achieved. At current, rock-bottom prices, the CERs that would be delivered into ETS phase III are probably not additional, since projects that really require CER income will cease to operate. Further, current prices will provide absolutely no incentive to invest in projects in LDCs.

Three strategy options could be considered to address this challenge:

1. Increase the ETS demand for eligible CERs. This would only be compatible with increasing the severity of the target (options a or c), as a compensating measure for additional flexibility to facilitate compliance.
2. Increase the European demand for ETS eligible CERs. Article 5.1(b) of the Effort Sharing Decision allows Member States to use *"CERs and ERUs issued in respect of emission reductions from 1 January 2013 from projects which were registered before 2013 and which were eligible for use in the Community scheme during the period from 2008 to 2012"*. This provision is, in essence, a back door so that HFC23 and other disallowed projects for ETS can be used by Europe's sovereign buyers for 2013-2020. To achieve level playing rules between ETS operators and their governments, and considering the sound arguments regarding environmental integrity that led the Commission to disallow such CERs in the first place, this Decision could be updated in line with ETS' qualitative restrictions. Nevertheless, this option might face considerable political obstacles.
3. Increase the qualitative restrictions for ETS eligibility. To be effective, this would need to stipulate qualitative restrictions that are, de facto, more stringent than the quantitative limit. Were this to occur, ETS-eligible CERs would once again see their prices pegged to the EUA. New projects in LDCs could go forward. To implement this measure, the Commission would "cherry pick" eligible project types under Article 11a.9 of the Directive. An example of such "cherry picking" would be to limit projects registered before 2013 from non-LDCs to small-scale CDM project activities as per Annex II of 4/CMP.1. This would essentially pair the SSC project activities world-wide to the ETS (about half of the over 6,000 registered projects). Obviously, neither Europe nor ETS can save the CDM from the surplus of Kyoto units, but ETS

alone could save this most valuable half of the CDM. It also would be a bold step forward to avoid the increasing consternation of CDM project owners that, if not addressed urgently, is guaranteed to thwart the new market mechanism or any other mechanism to foster future private investment in climate change, other than up-front grants or concessionary loans.

***Sound policy: One solution for each problem***

As a final comment, sound policy-making dictates one solution (instrument) for each problem (goal). The EUA surplus and resultant depressed pricing are symptoms, not the root cause. There are several underlying problems, identified above, each of which requires a policy response. Therefore, we encourage the Commission to consider not one solution, but rather a complete and coherent set of solutions - one for each of the problems identified:

<b><i>Problem / Goal</i></b>	<b><i>Solution / Instrument</i></b>
Phase II economic growth was lower than originally projected.	Set aside a reserve of up to 800M phase III EUAs to auction in the future when growth exceeds projected levels.
Phase III and future caps are based on phase II caps, thus grandfathering phase I over-allocations permanently into ETS.	Revise the cap setting mechanism for phase III and future phases to consider real, verified emissions instead of phase II allocations.
Phase II and future caps ignore the allowed use of international credits.	Deduct 50% of allowed credit use from future caps, thus sharing their use between volume flexibility and cost-effective compliance.
About half of the phase II surplus is due to grandfathering the phase I over-allocation and failing to consider international credits.	Permanently retire 800M to 1B phase III EUAs to compensate for the phase II over-allocation.
LDCs and the new market mechanism are not receiving the intended price signal based on the EUA.	Add further restrictions to the qualitative requirements of international credits (i.e. only SSC projects from non-LDCs) so that the portion of the CDM eligible for ETS receives a price signal pegged to the EUA.
This or any package of solutions for structural reforms to ETS poses a threat to compliance costs.	Increase the allowed use of international credits.

Once crafted, the set of solutions proposed by the Commission should be reviewed to ensure they are consistent and do not create additional, undesirable side-effects. The set of solutions should be backed by a credible economic impact analysis. This is especially important to ETS sectors that are threatened by carbon leakage.

CO2 Spain appreciates this opportunity to provide these comments to the Commission and would be pleased to provide additional information or analysis upon request.