Hermes Equity Ownership Services

Hermes Equity
Ownership Services Limited
1 Portsoken Street
London E1 8HZ
United Kingdom

Tel: +44 (0)20 7702 0888
Fax: +44 (0)20 7702 9452

www.hermes.co.uk

European Commission, Directorate-General Climate Action - Unit B.1
Submitted per e-mail: clima-ets-structural-measures@ec.europa.eu

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Dear Sir,

We are pleased to have to opportunity to express our views on the state of the European carbon market.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (EOS), we also respond to consultations on behalf of a number of pension funds and institutional investors from the US, Australia and Canada, as well as across Europe, including VicSuper of Australia, PNO Media (Netherlands), the UK's Lothian Pension Fund, BT Pension Scheme Management Limited and the BBC Pension Trust, and Canada's Public Sector Pension Investment Board (only those clients which have expressly given their support to this response are listed here). We assist these clients to act as good owners of the assets in which they invest. In all, EOS advises clients with regard to assets worth a total of over €100 billion (as at 31 December 2012).

As advisors to pension funds and long-term investors we are acutely aware of the economic implications of climate change. Prudence as well as our fiduciary duty compels us to increase our efforts to understand and manage material investment risks, including those resulting from the physical effects of climate change. We also actively consider the impacts of the introduction of regional national carbon pricing mechanisms. We believe it is crucial that environmental impacts are appropriately internalised into the functioning of the global market, so that investors can more actively consider these important impacts, and we see a functioning carbon market as a crucial step towards this goal.

We view a European carbon market as complementary to national decarbonisation measures, and we believe that its short- and long-term effectiveness must be secured if it is to emerge as a primary driver towards a low-carbon economy. By effectiveness we mean both its functioning as a marketplace with an appropriate balance of supply and demand and its ability to deliver tangible and sustainable emission reduction carbon technologies and allow investors to integrate environmental impacts more meaningfully in their decision-making.

We welcome the Commission's efforts to tackle the structural supply-demand imbalance currently existing within the European Carbon Market.

To that end, we favour a combination of options a (Increasing the EU reduction target to 30% in 2020), b (Retiring a number of allowances in phase 3) and c (Early revision of the annual linear reduction factor). We believe that short-term intervention in the market is essential to restore its functionality. The present surplus in supply as well as projected oversupply in the absence of intervention lead us to believe that it is necessary to employ short-term measures before more far-reaching measures can take effect. While we recognise the considerable implications of revising the linear reduction factor, we are convinced that the free allocation needs to be altered if a reasonable balance of supply and demand in the European carbon market is to be achieved in the long-term. Furthermore, this will deliver the certainty of direction that companies need in order to commit to a permanent shift towards lower carbon operations.

We discuss the different options in more detail below.

Yours sincerely,

PAUL LEE
Director

A. Option a: Increasing the EU reduction target to 30% in 2020

We believe that a more ambitious target is necessary in order to ensure that the value ascribed to carbon is robust enough to sustain an operating market, which will deliver a price for carbon that begins to reflect its externalised costs. While we are aware of the potential risk of carbon leakage (transfer of operations into countries facing fewer constraints from decarbonisation measures), we do not at present see the price of carbon as a major driver behind relocation of industry. A recent study found no hard evidence that carbon leakage has occurred in the aluminium sector since the introduction of the ETS[1]. Although at present not included in the scheme itself, this sector is highly exposed to the cost of carbon as it is very electricity-intensive. The paper comes to the important conclusion that the significant drivers for delocalisation in the case of that sector have been factors such as relative energy prices, exchange rates, and contracting arrangements in domestic electricity markets.[2] Although subject to several caveats, the modelling used in a 2010 report for the UK Department of Energy and Climate Change also found that a 30% target does not impact production loss in a way significantly different from a 20% target, except for sectors already strongly influenced by carbon prices.[3] We believe that in order to create a solid argument against a stronger target, stronger empirical evidence is required that a lower carbon price as such will prevent delocalisation of businesses, all other things being equal. In our view, it is crucial not to ascribe to the carbon price losses of competitiveness stemming from other factors. While we agree that appropriate mitigation policies are necessary to absorb some of the potential impact of carbon leakage, we do not see this as an argument against a strengthened reduction target.

B. Option b: Retiring a number of allowances in phase 3

As mentioned above, we see this option as a necessary measure to restore the function of the market in the short term. However, we are wary of suggesting it as a stand-alone option, because we believe it fails to address the fundamental oversupply in the market over the longer term. While it will provide a welcome

[1] Sartor, Oliver, Carbon Leakage in the Primary Aluminium Sector: What Evidence after 6.5 Years of the EU ETS? (January 22, 2013). USAEE Working Paper No. 13-106. Available at SSRN: http://ssrn.com/abstract=2205516 or http://dx.doi.org/10.2139/ssrn.2205516.

[2] Sartor, p. 16.

[3] Report by Cambridge Econometrics for the Department of Energy and Climate Change, published on 15 September 2010, available under https://www.gov.uk/government/publications/an-assessment-of-the-degree-of-carbon-leakage-following-an-international-agreement-on-climate-change

support to the carbon price and some reduction to the oversupply in the market, it should be complemented and supported by measures which are more long-term in effect.

C. Option c: Early revision of the annual linear reduction factor

We see this measure as one of the priorities among the ways of tackling oversupply. It is a necessary prerequisite to achieving a more ambitious overall reduction target, and it is capable of delivering structural changes to the supply-demand dynamic in the market. This measure has the added advantage of providing a degree of certainty and setting a strong signal for the EU's commitment to CO2 reduction. This should create a stronger incentive for companies to invest in low-carbon technologies and therefore increase competitiveness within that sector. It will also go some way towards making available decarbonisation technologies more economically viable and drive the investment case for further research and development.

If the framework within which the carbon price develops is able to provide a degree of predictability, it could also allow investors to integrate climate considerations into their decision-making in a meaningful way. This, in turn, could reduce the speculative element of certificate trading and contribute towards reducing the volatility of the pricing of permits.

This measure is, together with option (a), crucial for the overall ambition and strength of the ETS. It is both a necessary tool for the achievement of the outcome envisioned in option (a) and a necessary complement to option (b). As such, we see a reduction in the linear factor as a central precondition of an effective reform of the ETS.

D. Option d: Extension of the scope of the EU ETS to other sectors

While we are aware of the fact that a number of international carbon trading schemes have started to expand into additional sectors, we do not see this as a prerequisite to restoring the function of the European market. Including sectors less strongly influenced by economic cycles in the present scheme will only have a significant effect on overall reductions if the structural imbalances of the scheme are removed. These imbalances are only partially caused by economic cycles. Therefore, we do not see the addition of new sectors into the ETS as a priority at this point.

E. Option e: Use access to international credits

While we realise that use of international credits, such as CDM credits and credits under the Australian carbon trading scheme, contribute to the surplus present in the European market, we do not believe that it is the root of the problem. We do not see international credits as the key driver of the surplus, but rather the levels of free allowances and projections on which these are based. Hence, restricting access to international trading schemes, while providing, possibly, partial support for demand, does not tackle the causes of the oversupply and has downsides that outweigh its advantages. We also believe that access to international carbon trading schemes is an important step towards establishing a worldwide carbon market and achieving a degree of coordination in decarbonisation efforts in the absence of an international treaty. In our view, there is no good reason to jeopardise the EU's important role in facilitating the international effort in this area.

F. Option f: Discretionary price management mechanisms

We believe that the final goal of any structural changes to the carbon market should be a marketplace that is largely able to function on its own without requiring regular intervention. We are however conscious of the fact that a suitable minimum price could provide more certainty for market participants and thus play a role in driving low-carbon investment. While our focus is on measures more directly related to the environmental objectives of the scheme, we recognise that price management mechanisms could increase investor confidence.