

26 February 2013

To the European Commission

Fortum's response to the EU Consultation on structural options to strengthen the EU Emissions Trading System

Fortum is a Nordic power and heat company whose operations focus on the Nordic countries, Russia, Poland and the Baltic Rim area. Fortum has 79 installations in six EU member states in the EU Emissions Trading Scheme. About 95% of Fortum's CO₂ emissions in the EU are included in the ETS.

Fortum is registered in the European Commission Transparency Register, ID Number 03501997362-71.

1 FORTUM'S POSITION IN A NUTSHELL

Fortum is strongly committed to climate change mitigation and supports cap & trade-based emissions trading as the main climate policy instrument in Europe. The European Emissions Trading System (EU ETS) should not be seen in isolation, but in a context of other climate and energy policy targets and measures set and implemented both on the EU and national levels. In that background, Fortum considers the following measures necessary to strengthen the incentives generated by the EU ETS:

- Short-term (2013-2020): the back-loading of 900 million allowances should be implemented without delay and should be followed by a permanent set-aside of allowances.
- Long-term (after 2020): Firstly, a clear decision on the post-2020 climate and energy policy target framework should be made as soon as possible and should put the EU ETS at the centre to steer the EU climate policy. Other targets that have overlapping effects on the EU ETS – targets like those on renewable energy sources, energy efficiency and taxation – must be supportive of the EU ETS, if needed at all. This applies to the targets themselves as well as to the measures by which they are implemented in order to avoid a situation in which they water down the incentives of each other.

Secondly, CO₂ reduction targets based on the EU Climate Roadmap should be set for 2030, 2040 and 2050. The cap of the ETS should be adjusted in accordance with these targets by increasing the linear emissions reduction factor latest from 2020 onwards. In addition, extension of the ETS to new sectors should be carefully analysed.

This kind of long-term policy framework would affect all sectors of society and would ensure the environmental goal of the system is reached in a cost efficient way. The ETS would continue as a genuine quantity-based market mechanism where the price of CO₂ is set by the supply-demand balance.

Fortum highlights the need of the ETS to be able to adjust to economic cycles. Although the ETS should be a true market mechanism, provisions for extreme economic fluctuations may be needed as a safety valve in the ETS and to ensure the necessary investment incentives. An automatic and pre-designed mechanism to adjust the ETS in cases of significant deviations in economic development should be investigated. Fortum considers a supply-demand management reserve worthy of investigating for this purpose.

26 February 2013

2 FORTUM'S VIEWS ON THE CARBON MARKET REPORT

2.1 The state of the carbon market

Since the very beginning of the ETS, Fortum has preferred it as a market-based climate instrument. We have emphasised that energy market prices shall reflect the cost of carbon dioxide emissions. In our opinion, the ETS has been working as intended, delivering the emission reductions (environmental goal) in a cost-effective manner (economic goal). The system has, in principle, adjusted to external changes, like economic cycles.

However, the ETS has recently been characterised by a significant surplus of allowances as well as lower and more volatile allowance prices than expected. As a consequence, the ETS has been weakened as a climate instrument, failing to generate the right incentives for low-carbon investments during extreme economic downturns.

In Fortum's opinion, this is largely due to the intervention by overlapping policy measures that have watered down the ETS mechanism. The carbon market report does not recognise the impact of other policy measures on the EU ETS, but mainly points out the economic downturn as a reason for the current state of the ETS market. This is a major defect in the report.

Fortum believes that the ETS should continue as the main climate instrument, but both long-term and short-term corrective changes are required to allow for proper functioning of the carbon market. Provisions to maintain the necessary investment incentives during periods of sharp economic fluctuations must be introduced.

We foresee an increasing risk of the ETS being replaced by diverging national policies. This development would not only distort and fragment the internal energy market, but also increase uncertainty, reduce predictability and result in huge additional costs for the decarbonisation of the economy.

The future of the ETS must be seen in connection with the future climate target-setting. The Carbon Market Report delinks the reforms of the EU ETS from the 2030 framework. If the EU ETS is to remain as the cornerstone of the future energy and climate policy, it must be integrated into the discussions on post-2020.

2.2 A review of the auction timetable as the short term measure

The proposed back-loading of 900 million allowances should be seen as a first, but necessary, step in the reform of the ETS before 2020. A temporary back-loading will increase the regulatory risk, but most likely will not decrease market volatility. A temporary back-loading is necessary, however, in order to restore trust in the endurance of the market and to increase the carbon price signal for low-carbon investments. A short-term action also gives time to work out longer-term structural changes and reduces the risk of applying more and more national and regional approaches.

Fortum would prefer a permanent set-aside of allowances from the market. The volume of the set-aside should be well defined and linked to the estimated impact of the overlapping policy measures on the ETS.

The back-loading alone, without a permanent set-aside of allowances from the market, should have no material effect on the allowance price, but as long as the market expects the set-aside to be materialised later, prices will be lifted along with the decision on back-loading.

26 February 2013

2.3 Options for structural measures

The carbon market report presents six options for structural measures. Below we provide our views and arguments regarding each of them.

(a) Increasing the EU reduction target to 30% in 2020

The EU has fixed the targets for 2020 regarding greenhouse gas reduction, renewable energy and energy efficiency. Also the EU ETS legislation and rules have been approved for 2013-2020. Reopening this package and revision of the ET Directive is not appropriate.

The 2020 target should be considered as a milestone and not as an ultimate target. The investments in energy production to be made up to 2020 will remain in the system until 2050, and therefore it is important that the ETS gives the adequate investment signals already today.

Fortum prefers setting an ambitious economy-wide greenhouse gas reduction target for 2030 consistent with the long-term decarbonisation pathway up to 2050. Based on the 2030 target, the cap of the ETS should be adjusted, and it could be implemented already before 2020, having an effect of that year's target for the EU ETS sector.

(b) Retiring a number of allowances in phase 3

A permanent set-aside of allowances following the back-loading is needed to boost the carbon market in the short term, but it should be one-off measure. It is to be noted that this measure would affect only the EUAs to be auctioned and not the free allowances.

(c) Early revision of the annual linear reduction factor

Revision of the annual linear reduction factor is a tool to implement the greenhouse gas reduction targets for 2030 and onwards and the corresponding ETS cap. This measure has a long-term impact and affects all ETS sectors equally. The Commission roadmaps indicate a reduction target of 46-57% by 2030 in the ETS sectors. The revision of the factor should be applied from 2020 onwards, at the latest.

Any retirement in phase 3 should be integrated into a subsequent revision of the linear factor in order to bring the retirement into alignment with the longer term targets (2030 etc). Changing the annual reduction factor before 2020 removes the need to withhold phase 3 allowances as a specific measure.

(d) Extension of the scope of the EU ETS to other sectors

Fortum supports an extended scope of the ETS, because it could improve the cost efficiency of emissions abatement and decrease the volatility of the market. However, more analysis is needed to ensure that policies and measures currently applying to other sectors and gases are less efficient than the EU ETS and would thus be cancelled to avoid double regulation. Analysis is also needed, because many of the new sectors differ in nature from the existing ETS sectors.

(e) Limit access to international credits

Fortum opposes limiting the access to international credits.

The use of credits from the Kyoto mechanisms and emerging new mechanisms is important for the development of the global carbon market. The international credits are the first step to linking the various regional emission trading schemes on a path towards a more wide-ranging international trading scheme. As the EU and Australia already have announced to link their cap and trade

26 February 2013

systems, any suggestion to limit the access to international credits would be negative for the credibility towards getting a global system. California is also coming along with a cap and trade system and they should be encouraged link themselves towards the EU ETS. These mechanisms also play an important role in encouraging developing countries to commit to climate change mitigation.

(f) Discretionary price management mechanisms

As a back-up measure, provisions for extreme economic fluctuations may be needed in the ETS and should be further investigated. Because the supply of allowances is fixed in the ETS, any change in levels of demand is not reflected by a comparative change in supply.

In Fortum's view, the ETS should not target a specific price. Setting a reserve price is not appropriate and this would very much resemble a carbon tax.

Fortum therefore prefers reconsidering option (f) under a quantity-based perspective. Instead of a direct price management mechanism, a supply-demand management reserve would be worth investigating further, although we recognise that this would alter the nature of the ETS.

This kind of a pre-designed mechanism to adjust the ETS in cases of significant deviations in economic development should be transparent and predictable, and the rules for adjusting the supply should be determined in advance.

In a supply-demand management reserve approach, a surplus of EUAs to be auctioned could be deposited in a reserve in case of low demand. When the reserve exceeds a certain threshold volume, the surplus allowances would be permanently removed from the reserve. In case of increased demand, an amount of EUAs to be auctioned could be gradually released from this reserve when the surplus of allowances falls below the threshold. The mechanism would not change the total cap unless there is a political will to retire the surplus. In any case, the mechanism could ensure the system's scarcity in exceptional circumstances.

The reserve could be initially established by reducing the phase-3 auction volume by an amount corresponding to a substantial share of the accumulated surplus.

26 February 2013

3 IMPACTS OF STRUCTURAL MEASURES

Fortum highlights the need for decarbonisation in all sectors throughout the economy. This requires stable and predictable policy framework. The current weak ETS and the lack of targets beyond 2020 result in high political risks for the energy sector's investments.

A couple of remarks regarding the specific questions highlighted in the consultation request are below:

- *Impact on emission reductions*

Basically, there is no difference on the impact of different structural options on emission reductions, because it is the total cap of the ETS – not any structural measure itself – that defines the emission level. Setting the targets at the right level is essential in order to determine the environmental objective of the scheme. All structural options are tools to reach these targets. When the cap has been set, all structural measures should result in the desired emission reductions.

- *Impact on ability of the EU ETS to meet the EU long-term target of an 80-95% reduction in a cost-effective manner*

An 80-95% emission reduction requires efficient reduction measures in all sectors of society, not just the ETS sectors. Inside the ETS, reduction is being implemented in a cost-effective manner, as this is the underlying principle of the ETS. The wider the scope of the ETS, the more cost-effective the result for the whole society. Looking at cost-effectiveness alone, option (d) could provide the best prerequisites.

- *Impact on your activities or the activities of the business under your jurisdiction, including estimated changes in compliance and administrative cost*

Fortum considers both short-term and longer-term adjustments of the ETS necessary. In our view, option (b) is the only measure that can be implemented in the short term, even under the mandate of the existing Commission. All other options need more time to be realised.

The key issue for the energy sector is the certainty on the future policy framework and targets. Option (a) would not reduce this risk, but all other options combined with the target-setting for 2030 and onwards could increase the certainty and speed up investments in low carbon technologies.

Compliance and administrative costs as such are likely to be bearable in all options; a bigger concern is the expense of a non-ETS policy approach. Diverging national policies would result in huge additional costs for the decarbonisation of the economy.

- *Impact on employment and households*

The impact of the ETS on employment is related to the competitiveness of the European industry and on carbon leakage. Employment decreases if industrial activity leaves Europe as a consequence

26 February 2013

of high carbon prices. On the other hand, decarbonisation of the economy will result in green jobs and new business opportunities. The impact on employment is a complicated and extensive societal issue; assessing the impact of any individual option (a through f) is far too challenging in this context.

The impact of the ETS on households is related to the price of carbon and the ensuing price of energy for households. Basically, all measures to reduce CO₂ emissions will result in an additional cost for society and for energy consumers. The more cost-effective the emission reduction, the less the impact on energy prices.

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