

## **CONSULTATION ON STRUCTURAL OPTIONS TO STRENGTHEN THE EU EMISSIONS TRADING SYSTEM**

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### **0. Iberdrola**

Iberdrola, S.A. (“Iberdrola”) is a global energy company, active in the electricity and gas markets and listed on the Spanish Stock Exchange. In the European Union, its main presence is in Spain, where it has its headquarters, and in the United Kingdom, through its affiliate Scottish Power Limited. Iberdrola is included in the transparency register of the European Institutions with the number 41816938101-07.

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### **1. Introduction**

Iberdrola welcomes the opportunity to give its opinion on the EC public consultation on structural options to strengthen the EU ETS.

We agree that some changes will be necessary to the operation of EU ETS in the future to reflect the role that the scheme should play both in aiding the transition to a decarbonised economy and in underpinning the principles of the EU’s Internal Energy Market.

However, it is our view that any changes to the operation of the EU ETS need to be considered very carefully, with the benefits of any structural reforms balanced against the consequences of intervention in a market based EU wide mechanism which is delivering the previously stated objective of emissions reductions across EU ETS sectors.

It will be equally important that any changes to the EU ETS intended to support delivery of wider EU energy and climate change objectives are considered holistically. In this regard changes to the EU ETS should be considered alongside related policies in respect of renewables and energy efficiency, to avoid inconsistencies and ensure the overall policy framework is clear to investors.

It is recognized that the role of EU ETS will over time need to evolve in a way that can encourage energy switching alongside the overarching aim of GHG emissions reduction. For EU ETS to be effective in the future, it must be able to assist in the promotion of efficient technologies from an economic and environmental standpoint.

Iberdrola therefore believes that option c “Early revision of the annual linear reduction factor” represents the most effective means of refocusing the EU ETS to achieve an improved objective in a controlled and transparent manner. Early consideration of the

reduction factor would, strengthen carbon prices allowing them to be fully reflected in investment decisions now being contemplated for the post 2020 period.

## 2. What should be the objectives for the EU ETS Structural Measures?

Iberdrola supports the principle of emissions trading as an effective tool to reduce emissions and, alongside other policy initiatives, to stimulate investment in the decarbonisation of the energy sector. We agree that action will be required in the coming years to improve the operation and relevance of the EU ETS.

Within this context the EU ETS's main objective to date has been to provide the GHG emissions reductions determined by regulation in an efficient way i.e. by minimizing the cost of achieving such reductions. Reductions in emissions are delivered in the short term through operational decisions and in the long term through investment decisions, both of which can be impacted by external factors such as the general macro-economic environment or relative changes in global commodity markets.

Short term carbon prices affect mainly short term operational decisions. Although short term prices can influence long term price forecasts in which investment decisions are at least in part based, it is the long term policy framework that ultimately determines the overall investment climate from which investment decisions are derived. The weaker the visibility and predictability of such long term frameworks, the more difficult it will be to take such investment decisions efficiently and on a timescale consistent with achieving decarbonisation policy objectives.

A strong EU ETS does not necessarily mean high carbon prices. A strong EU ETS means a reliable framework for making investment decisions i.e. to promote efficient low carbon investment. Therefore the real strength of the EU ETS should be based on three pillars:

- A solid and trustful administrative structure.
- The long term commitment to achieve deep GHG emission reductions.
- Objective and stable regulation that clarifies the specific role of the EU ETS in achieving such reductions, and any interactions with other policy initiatives in this area.

This is the way to provide the scheme with enough visibility and predictability for long term investment decisions in EU ETS sectors so that the cost of emitting is properly taken into account and reflected in the final price of products. In this sense, any arbitrary intervention in the electricity markets to avoid the consequences of the implementation of the EU ETS, i.e. regulated prices, should also be forbidden.

It is our opinion that the administrative structure of the EU ETS is, in general terms, working properly. Although there is always room for improvement, it is clear that the improvements to be made are in any case in the other two pillars are where substantial improvement needs to be targeted. Equilibrium needs to be reached between the stability of the regulation and the need to support the EU ETS price in the shorter term.

### 3. The State of the Carbon Market

In our opinion, while the economic crisis continues, uncertainty and low energy demand will influence investment decisions in the near term. Therefore short term carbon price is not particularly relevant as an investment signal at the moment. If an intervention results in a very significant price increase, gas could substitute coal, for example for power generation, and emissions will be reduced at short term depressing again carbon prices till equilibrium could be reached. However, overall global emissions (short and long term) will only be reduced by changing the long term objective.

However, we agree that it is important that a long term framework is established and that this framework is clear enough by the time new investment decisions are about to be taken, i.e. when the economic crisis gives way to economic growth.

In summary, we see that the main barrier for the EU ETS in complying with its final objectives is primarily related to the absence of a long term commitment, the need for visibility on the long term role of the EU ETS<sup>1</sup> and the long term reliability of the regulation framework, rather than the short term market situation which is clearly linked with the current economic crisis. This long term commitment and visibility should also be applied to the electricity market accepting all changes resulting directly from the implementation of the EU ETS.

### 4. Structural Measures for improving the EU ETS proposed in the Report.

When considering the EU's long term commitment to GHG emissions reduction, it is crucial to understand the role of the EU ETS in achieving such commitments. For this purpose, once the burden sharing between EU ETS and non-EU ETS sectors is made, it is important to define other EU policies that affect EU ETS sectors' emissions such as renewables and energy efficiency policies, and their interaction with the EU ETS.

As a result, it is clear that any reform of the EU ETS needs to be considered as part of a holistic long term energy and climate change policy. In this regard it is important to give as much long term visibility and predictability to such policies in order that their impact on the EU ETS sectors can be forecast and that they can influence the investment decision making process in a timely manner.

In any case, if additional measures are adopted for the EU ETS sector, equivalent measures must also be adopted for the non-EU ETS sectors in order to keep a balanced overall approach.

Regarding the Structural Measures that have been proposed in the Report, our opinion about each one of the options is summarized below

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<sup>1</sup> The EU long term emissions reduction target will only be part of the definition of the role of the EU ETS. As important as the target itself is the effort sharing between EU ETS and non-EU ETS sectors and also any other policies that affect GHG emissions in EU ETS sectors (currently the most important ones are renewables and energy efficiency policies).

#### **4.1. Option a: Increasing the EU reduction target to 30% in 2020**

Currently the EU ETS target is based on a 20% reduction target in 2020. An increase in the level of ambition to 30% would only be considered should a global international agreement be reached; such an agreement is not probable at present.

Whilst increasing the EU reduction target to 30% in 2020 without an international agreement in place implies a willingness for the EU to take a leadership role in combating climate change, it could have significant detrimental impacts for the EU ETS.

It is our opinion that these types of changes jeopardize the capability of the EU ETS to provide enough visibility and predictability in the future. This intervention will unilaterally increase carbon and energy prices to 2020 but it is unlikely that there would be a significant impact on investment decisions without visibility of the longer term carbon price. Should the intervention succeed, electricity prices could be driven very high, raising the possibility of further intervention, either to mitigate the impact on domestic or industrial consumers, or to address concerns to energy security which could arise in certain Member States from rapid changes to the generation mix. This chain of possible interventions could therefore make the EU ETS incapable of providing a stable signal and driving efficient low carbon investment.

It is our opinion that new structural measures should not be aimed directly to raise current price levels. They should aim to give a more predictable and stable long term framework to develop new efficient investments and as a result, we are not convinced of the benefit of pursuing this measure unilaterally at a European level.

#### **4.2. Option b: Retiring a number of allowances in phase 3.**

This measure could be considered as a simplified version of Option a. However, it only affects the EU ETS, increasing the effort of EU ETS sectors relative to non-EU ETS sectors, deriving into a backdoor increase in the total EU emissions target. Reduction effort must be made in both sectors.

De-linking EU ETS emission reduction targets from the total EU emissions targets, increases the arbitrary nature of setting the cap for the EU ETS. Therefore, this intervention places undue burden on EU ETS sectors and further weakens the predictability and visibility of the scheme. We would not advocate option b for these reasons.

#### **4.3. Option c: Early revision of the annual linear reduction factor.**

Current EU ETS directive includes the possibility to review, in 2020, the annual linear reduction factor in order to be applied from 2025.

In our opinion, in order to improve the long term visibility and predictability of the EU ETS, it would be beneficial to start this review as soon as possible with the intention of applying a new linear reduction factor from 2020, with the overall objective of aligning the EU ETS with EU long term targets.

This proposal will:

- Maintain phase 3 parameters so preserving regulatory stability.
- Align the EU ETS long term targets with the EU's long term level of ambition for emissions reduction (2050).
- Establish a clear and predictable 2030 general emissions target, and spread it in an equitable way between the EU ETS and non- EU ETS sectors.
- Influence phase 3 carbon prices in a gradual way, establishing a manageable decarbonisation trajectory and allowing market fundamentals to work without risk of political intervention.
- Improve the visibility and predictability of the EU ETS, allowing the investment decision making process to take into account emission reduction objectives.

In our opinion this option would lead to a good equilibrium between preserving regulatory stability and reforming the EU ETS in order to improve its long term visibility.

#### **4.4. Option d: Extension of the scope of the EU ETS to other sectors.**

In our opinion it would be sensible to extend the scope of the EU ETS to other sectors including economy-wide fuel consumption. This extension will improve the efficiency of the scheme, as an efficient market mechanism is applied to more sectors in the economy. Applying the EU ETS only to industrial sectors leaves a very important part of the economy out of the effort for efficient emissions reductions. This measure could avoid the promotion of expensive emission reductions in current non-EU ETS sectors while less expensive reductions are available in the EU ETS sectors (or vice versa).

Finally, if the EU ETS is to be extended to all final fuel consumers, we would like to highlight that it will be important to coordinate these measures with fuel tax measures in order that the combination and interaction of each measures reflect the external cost.

#### **4.5. Option e: Limit access to international credits**

It is important that from 2020 onwards, a clear limit to the use of international credits is implemented alongside setting a long term target for emission reduction. This is crucial for EU ETS participants to determine the role that EU ETS sectors will play in achieving the EU ETS cap.

#### **4.6. Option f: Discretionary price management mechanisms**

In general terms, the process for establishing the true economic cost of carbon is best determined via market principles, and not through discretionary price management mechanisms. The application of price management mechanisms would radically change the way the EU ETS works and has the potential to increased regulatory risk through opening up the market to unforeseen intervention. The efficiency of the system could be deteriorated by any price limits externally imposed.

It is our view that the operation of EU ETS without price limits is the best way to set the economic price of carbon. Any price coming from external considerations will jeopardize EU ETS efficiency. Moreover, if the mechanism allows external parties the capability of modifying price levels, this possible future modification of price levels could introduce such uncertainties into the EU ETS that efficiency of the scheme will be further undermined.

Where discretionary actions are taken, it is important that they are taken at a European level, as interventions within individual Member States undermine the effectiveness of EU ETS and could undermine the implementation of the Internal Energy Market.

However, we strongly believe that if, even after taking consideration of the foreseen losses of efficiency, there is a desire to control the carbon price, it is much better and clearer to control it directly through objective mechanisms than trying to control it indirectly through modifications to the cap or the quantities involved in auctions.

## 5. Summary.

In our opinion, the best way to proceed with the structural measures in the EU ETS is to establish a process to revise the annual linear reduction factor as soon as possible in order that this new factor could be applied from 2020. This would give a clear signal on where the target emission levels will be in 2030 and beyond to achieve wider climate and decarbonisation policy objectives, and would achieve a clear equilibrium between regulatory stability and EU ETS visibility and predictability.

If the implementation of this revision is accompanied by an extension of the EU ETS to other sectors, we believe the efficiency of the scheme could be significantly improved.

Both measures will provide a smooth and transparent increase in carbon prices to support policy objectives with no need for arbitrary interventions. It is important to take consideration of the need not to pursue price changes through untargeted volume changes and instead focus on improving the long term visibility and predictability of the system. We believe that these measures that will provide more certainty in the investment decision making process and could lead to more efficient investment in low carbon technology.

Moreover it is essential to set the long term framework for any other policy that could affect EU ETS sectors emissions (in particular renewables and energy efficiency policy) in a holistic manner alongside carbon market reform. This is the only way EU ETS participants could really know their long term role in achieving the EU ETS target.

Finally, while we are aware that there are numerous difficulties in implementing many of the suggested reforms (both from a regulatory and political point of view), we strongly believe the proposals outlined above would deliver significant improvement in the operation of the EU ETS and the overall carbon market. Moreover, we are not convinced that short-term market interventions will provide the required clarity in regulation or long term political commitment necessary to deliver substantial reductions in GHG in a way that is affordable for EU citizens.