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BELGIUM

EU Transparancy Register: 64436972598-17

Response to European Commission Consultation on Options to Reform the European Carbon Market

Introduction

SSE - EU Transparancy Register: 64436972598-17 is a leading energy company, operating mainly in the United Kingdom (UK) and Ireland. It is involved in the generation, transmission, distribution and supply of electricity and the storage, distribution and supply of gas. SSE strongly supports the EU ETS as one of the main policy tools for achieving the EU Council's target of a reduction in GHG emissions of 80-95% by 2050. A properly functioning ETS with an appropriate reduction in supply of carbon emission allowances (EUAs), together with effective support for renewables – is an essential instrument to drive investments in carbon reduction. The system is technology neutral, provides the mechanism to drive cost-effective investment choices in CO_2 reduction, and is fully compatible with the Internal Energy Market. SSE believes that the ETS is not currently functioning optimally, and believes that the Commission is justified in taking strong action to ensure that the ETS provides a meaningful signal to investors in the short and long term.

Restoring the EU ETS requires structural, longer term measures,

SSE agrees with the Commission in its analysis of the current structural surplus of allowances in the ETS, noting that the carbon market is the only known market where there is no supply reaction to falling demand. The over-allocation of allowances in the first phases of the ETS combined with the unforeseen economic crisis from 2008 onwards have radically altered the demand profile for allowances, but the Commission has been unable to remedy this structural imbalance until now. Indeed, SSE believes that this imbalance is likely to be larger even than the Commission estimates, with market commentators noting that a surplus of 2.2 bn allowances has removed the planned scarcity in the market[1]. SSE also agrees that the current state of the market has important implications for the EU's post-2020 policy framework and for the development of an international carbon market.

SSE strongly agrees with the Commission's statement that the ETS will need to play an increased role in the transition to a low-carbon economy by 2050, together with measures to support the development of renewables. With the current trend for climate policies to be set at national level through the introduction of instruments such as the UK Carbon Price Floor, the Netherlands' coal tax and several possible

[1] http://www.sandbag.org.uk/site_media/pdfs/reports/Losing_the_lead_modified_3.8.2012.pdf

national carbon taxes, we see a serious risk that a non-ETS approach to de-carbonisation will not only distort, but also fragment, the Internal Energy Market.

Furthermore, with international negotiations in the UNFCCC proceeding slowly, showing the world that the EU remains committed to a long-term strategy of driving carbon reduction through a strong ETS is crucial to securing a global level playing field in climate action.

<u>A 2030 climate and energy package should include binding targets on carbon reduction and renewables</u>

SSE believes that the 2020 emissions reduction target should be increased in ambition to 30%, with a substantial part of this increase being accounted for in a strengthening of the ETS via an increased linear reduction factor. Increased ambition in the period to 2020 is vital if the ETS is to be restored as a meaningful climate policy tool in the short term (i.e. during Phase 3).

Looking ahead to 2030, SSE sees some confusion from the current EU policy processes with the implementation of the Energy Efficiency Directive, the report on the Renewables Directive, and the debate on ETS back-loading and structural measures. These processes are located in different parts of the EU institutions, working to different and non-aligned timetables. SSE therefore welcomes the Commission's intention to prepare a 2030 framework paper, while still calling for a single, coherent and finite process of EU decisions which links together agreement on a whole-economy 2030 target, on the ETS Phases 3 and 4, and binding 2030 targets for renewables and energy efficiency. We are anxious that this process is moving slowly, and we urge that it should be substantially completed during the current Commission mandate. If decisions are not taken now, we foresee that a new Commission working with a new Parliament from 2015 is unlikely to agree the necessary measures before 2017 at the earliest – far too late to save the ETS and far too late to enable our sector to decide on investments for the years beyond 2020. Our business invests in large scale and long term projects with long lead times. For us 2020 is tomorrow.

<u>Best options are setting (more) ambitious carbon reduction targets for 2020 and 2030 and a stricter annual reduction factor</u>

The Carbon Market Report offers six options for structural measures, (a) to (f). SSE has assessed the options in relation to two objectives:

- Securing the long-term role of the ETS as the key policy driver for CO_2 emission reduction in an EU 2030 climate and energy package;
- Maintaining the credibility of the ETS in the short term before 2020.

On this basis, SSE believes that:

- Option (a) - increasing the EU's carbon emissions reduction target for 2020 from 20% to 30% below 1990 levels; is a highly desirable outcome, but is best achieved through explicitly implementing either Options (b) or (c).

- Option (b)for retiring allowances during Phase 3 from auction is SSE's second preferred option. As noted above, SSE believes that the built-in structural surplus in the ETS is likely to reach 2.2 bn allowances. Therefore any plan to retire allowances must be ambitious enough to remove this structural surplus.

Removing 900m allowances is unlikely to be sufficient, but any reduction would be welcome – particularly one that can be achieved quickly. It is also worth noting that by retiring allowances due to be auctioned over the course of Phase 3, the power sector is likely to bear the brunt in any change in the carbon price, while industrial sectors are likely to be protected by existing reserves built up during the period of oversupply.

- **Option (c)** revising the 1.74% annual reduction in the number of allowances to make it steeper**is SSE's preferred option. We believe that an urgent review of the linear factor is required to put the EU on track for a 30% emissions reduction target in 2020 and an ambitious emissions reduction target for 2030 in line with the overall 2050 target set by the Council.**
- Option (d) of extending the scope of the ETS is not the most pressing issue facing the ETS at present and would not have a significant impact on the short term credibility of the ETS. Furthermore, past experience shows that new sectors in the ETS tend to be over-allocated allowances during the first years of their participation. Extending the scope of the ETS could therefore make the oversupply situation worse in the short term.
- Option (e) Limiting access to international credits would be a useful additional measure to Options (b) and (c), but is not a central concern at present. It may be better considered in 2015, in light of the outcome of the UNFCCC Durban process towards an international climate change agreement.
- SSE does not believe that Option (f) for introducing a discretionary price management mechanism would be the most appropriate response to the current issue of oversupply in the ETS. Such a move "would alter the very nature of the current ETS being a quantity-based market instrument [so that] the carbon price may become primarily a product of administrative and political decisions (or expectations about them), rather than the interplay of market supply and demand."

SSE therefore gives top priority to Option (c) for an early revision of the annual linear reduction factor in line with an ambitious 2030 target. The revision of the current 1.74% linear factor is necessary in order to meet the EU goal and early revision has the clear merit of providing a stable long-term framework. SSE's recommendation on the percentage for the new linear factor would depend on having clarity on the economy-wide greenhouse gas emissions reduction target for 2030, the burden sharing between the ETS and non-ETS sectors and the role of international offsets into Phase 4. However, we recognise that a later revision would require a steeper linear factor in order to reach the same target.

In SSE's view, Option (b) for a retirement of EUAs in Phase 3 has both advantages and disadvantages. We see Option (b) as clearly subsidiary to Option (c) but also closely linked; the case for Option (b) depends on when the revised linear factor can come into effect. Certainly a one-off retirement of EUAs would be an insufficient measure on its own, because it does not provide the necessary long-term signal; on the other hand, Option (b) can have a speedy impact, re-establishing market confidence in a relatively short time, which may not be possible using Option (c) alone.