

## **Executive summary - IETA's vision for a comprehensive EU ETS reform**

IETA welcomes the launch of the debate on structural reform of the EU ETS and the opportunity to respond to this consultation on a set of reform options.

IETA supports the ETS as the cornerstone of the EU's climate policy. It has achieved emissions reductions at a low cost, given its flexibility and links to the Kyoto mechanisms. Most importantly, it has raised awareness in corporate boardrooms of the cost of carbon emissions and the value of investments aimed at emissions reductions – and stimulated the formation of a new cadre of carbon entrepreneurs, financing experts and service providers. This market infrastructure is in serious decline, given the impacts of the economic problems in Europe. Meanwhile, the climate problem remains serious, and more needs to be done to mitigate emissions. Thus, we believe it is the right time to consider structural improvements in the EU ETS.

The EU ETS is at a crossroads. It will play a critical part to put the EU on a cost efficient path to the long-term emissions reduction targets policy makers are about to set. IETA believes that structural reforms to the EU ETS thus need to be discussed as part of the wider future policy framework post-2020. We have structured our response accordingly.

### **1. The EU ETS reform should be driven by a reaffirmed and clarified policy ambition to decarbonise the EU economy.**

The main driver for the EU ETS revision should be setting a binding EU-wide GHG emission reduction target for 2030, consistent with the 2050 ambition. The EU ETS cap - and its annual linear reduction factor - should be the main tool to reach this target. Hence, the 2030 target should serve as the main reference for the review of the EU ETS.

In that regard, out of options a, b and c put forward in the Carbon Market Report ("the Report"), **IETA believes option c (to revise the reduction factor) should be examined in priority**. What this new reduction factor should be - both in terms of timing and magnitude - should be decided in line with the most efficient emissions trajectory to deliver the 2030 EU-wide GHG target. The Commission would need to conduct a comprehensive analysis on the feasibility and benefits of introducing a revised linear reduction factor before 2020 compared to after 2020.



## **2. The EU ETS should remain the central pillar for delivering on that ambition cost-effectively, which will require managing interactions between the EU ETS and other policy mechanisms impacting EU ETS sectors' emissions directly or indirectly.**

Whilst recognising the past achievements of the EU ETS, we believe a thorough understanding of the challenges that the EU ETS is faced with is necessary to inform a successful reform of the scheme. In that regard, it comes as a surprise that the Report does not mention interactions between the EU ETS and other policy measures - in particular in the field of energy policy, at EU and/or national level - that may have muted the emission reduction signal the scheme is expected to provide whilst actually promoting more expensive measures in some cases. IETA understands that addressing this issue requires looking beyond the scope of climate policy and the EU ETS. We encourage the Commission to focus on those interactions in the forthcoming debate on the 2030 Climate & Energy package and as a part of the reform process of the EU ETS.

## **3. The case for enhancing the EU ETS' resilience to shocks needs careful examination.**

As a principle, IETA dislikes measures that have the potential to add regulatory complexity. We recognise however that external circumstances - such as economic conditions or the impact of overlapping policies - can change in a dramatic manner. Accordingly, we see a potential role for EU ETS design changes that would allow some form of clearly-defined flexibility in allowance supply, within the envelope defined by the cap. **Two fundamental principles should govern any such mechanism. First, it should be operated in a transparent, independent and predictable manner. Second, it should be triggered by quantitative thresholds, not price levels.**

In this regard, a dynamic allowance reserve and/or free allocation based on actual output are mechanisms that deserve a careful and objective assessment, whilst an auction reserve price would come with too many shortcomings. Those mechanisms may be best generally categorised under the broad heading of the Report's option f. Note that many of the other option f mechanisms in the CMR are disqualified by the above principles as being "discretionary" or aiming to manage prices.

## **4. The import of international credits in the EU ETS has many important roles to play.**

International credits - from existing and future mechanisms - are a powerful tool. Domestically, they contribute to the cost-efficiency of the EU ETS and have allowed the carbon finance industry to emerge. Internationally, they transmit the EU carbon price signal beyond its borders, contributing to the development of an international framework of climate change mitigation measures from the bottom-up, with the



promises of a more level playing field for carbon intensive activities trading internationally, and as standardised and transparent commodity they could serve as an instrument to link different trading regimes. For all those reasons, IETA strongly supports the continued use of international credits in the EU ETS. However informed decisions can only be taken looking at the bigger picture including forgoing free allocation at installation level and auction revenue for Member States as well as the level of domestic reductions to be achieved in order to ensure effective decarbonisation of the EU economy.



## **Introduction**

The International Emissions Trading Association and its +140 members, welcomes the publication of the European Commission's report on the 'The State of the European Carbon Market in 2012', as well as the launch of this stakeholder consultation on long term options for a structural reform of the EU ETS.

**Looking back at achievements of the scheme, the EU ETS is successful in many respects:**

- EU-wide, robust infrastructure and processes have been established over time to (i) monitor, report, and verify emissions, (ii) track, auction and transfer emission allowances, and (iii) manage and transparently ensure compliance of installations covered by the scheme
- The emergence of a transparent and reliable carbon price across Europe, anchored in a structured, well functioning and liquid carbon market
- Successful enforcement of an absolute emissions cap on EU ETS sectors, with significant volumes of emissions reduced as a direct result of the EU ETS price signal<sup>1</sup>
- A first successful legislative reform in 2008 based on the lessons learnt from the pilot phase, leading to a harmonized allocation process
- An international reference and an encouraging example for the current development of emissions trading schemes globally

Despite these successes, the context in which the EU ETS operates has changed, and the scheme is facing a growing number of challenges.

This consultation process should not be confused with the on-going debate on the backloading option proposed by the Commission, which is aimed at restoring market balance in the short term without changing the total supply over the phase.

IETA therefore welcomes the start of this separate debate on structural measures and on providing greater clarity on the EU's post-2020 ambition, in order to maintain the EU ETS as the central pillar of the EU's climate policy in the long-term.

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<sup>1</sup> The Environmental Defense Fund estimates that "the ETS was responsible for reductions of more than 480 million tons of CO<sub>2</sub>" over the 2005 to 2009 period (*The EU Emissions Trading System – Results and Lessons Learned*, Environmental Defense Fund, 2012)



## 1. The need for reform

- Structural reforms suggested by the Carbon Market Report primarily aim at tackling the current oversupply in the EU ETS. For the EU ETS reform debate to be successful, we believe the wider range of challenges posed to the EU ETS, as well as the longer-term policy ambition that the scheme is expected to support, also need to be considered.
- The EU ETS is a tool created by EU policy makers to help deliver the climate change mitigation policy objectives at low cost, yet it is only as robust as the overarching decarbonisation ambition that underpins it.
- There is mounting evidence that the different mechanisms implemented to deliver the trio of the 2020 targets overlap and threaten to change the status of the EU ETS, from being the cornerstone of the EU's climate and energy policy to a marginal, short-term and residual abatement tool around decarbonisation investments triggered by other mechanisms.
- There is legitimate concern about the mechanism's resilience to severe demand shocks. Adjustments around an unchanged design may not be enough to ensure the EU ETS will remain effective and efficient over the longer term.
- To be successful, any reform should address the political challenges affecting the EU ETS.
- IETA believes that the Carbon Market Report needs to assess a wider policy and market context. Beyond Phase 3 there is a need for (i) a clarification of the post-2020 decarbonisation path, (ii) a clearer definition of the objectives of the EU ETS, and what its role in driving investments in low carbon technologies should be compared to other policy instruments such as transitional incentives, (iii) management of interactions of the EU ETS with complementary policies, (iv) EU ETS design reforms with appropriate transition phases.
- A successful reform requires effectively tackling the root-causes of the problem as opposed to temporarily addressing its symptoms (e.g. the current carbon price). A short-term adjustment to the supply and demand balance, based on today's expectations, is unlikely to restore the efficiency of the system on a long-term basis (thereby inviting multiple interventions over time, which is undesirable).
- IETA acknowledges that the above goes beyond the limited scope of the Commission's Carbon Market Report. But our position and proposals can only be understood and developed in this wider context, which we hope will also



usefully inform the forthcoming debate on a post-2020 Climate and Energy Package. Structural changes agreed during Phase 3 should serve to ensure an efficient EU ETS throughout the lifetime of the scheme.

## **2. IETA's long-term overarching objective**

In the context of the stakeholder consultation on the Carbon Market Report, IETA's members have agreed on an overarching objective, which will form the framework governing EU ETS design reforms.

**IETA's long-term vision for the EU ETS states the following:**

**We endorse the EU's 2050 vision for a low-carbon economy, and support a consistent, binding, economy-wide greenhouse-gas emissions reduction target for 2030 and beyond, while ensuring that the EU ETS remains the central pillar for achieving these targets cost effectively.**

It is important that greater clarity be given on the future purpose of the EU ETS post-2020. Political agreement on binding EU-wide GHG emission reduction targets is needed to clarify the decarbonisation path the EU will be taking, and hence provide better signals for low-carbon technologies. The final objective of the EU ETS is to reduce emissions in those sectors it covers by setting a cap and allowing trading to meet that cap at least cost. The traded price allows for investments in low carbon technologies to be considered as a means to achieve this end.

**IETA thus calls on EU policy makers to:**

- (i) Reaffirm and clarify their vision of a low carbon economy by 2050**
- (ii) Agree and provide a legal basis to a 2030 target, that would give clarity on the emission reduction path for the EU economy, the ETS and for non-ETS sectors**

IETA believes a market-based approach is the most cost-effective way of achieving climate change mitigation objectives. IETA therefore believes that the EU ETS should remain the central pillar of the EU's climate and energy policy. Whilst we recognize other policies play a role in incentivizing particular types of technology and in increasing energy efficiency on demand and supply sides, it is important that European policy makers ensure coordination between different policies. The current overlap of policies that aim to reduce CO<sub>2</sub> emissions is undermining the effectiveness of the different policy instruments and increasing costs of decarbonisation.



The discussion below analyses the six options put forward in the Carbon Market Report, in the context of IETA's agreed long-term vision for the EU ETS, and whether or not the proposed measure helps achieve its overarching objective.

### **3. Comments on the 6 options put forward in the Carbon Market Report**

#### **Option a – Increasing the EU reduction target to 30% in 2020**

In its “option a”, the European Commission proposes to raise the EU's GHG reduction target for 2020 to 30%. IETA welcomes the intention of the European Commission to ensure the EU's GHG reduction target is set at a level that is consistent with the 2050 objective of reducing emissions by 80-95% compared to 1990.

Moreover, according to the current legislation, the EU is currently committed to a conditional 30% GHG emission reduction target by 2020 if other developed countries commit to similar levels of ambition. The option to increase unilaterally the 2020 target has been discussed many times in the past, but it has failed to achieve sufficient political support due to concerns for the competitiveness of European industry.

Changing the 2020 EU-wide target is challenging. The conditions set in the 2008 Climate and Energy Package to move beyond 20% reduction by 2020 are still not met today. Moreover, changing the target risks opening up negotiations regarding the burden-sharing between Member States and between ETS and non-ETS sectors.

Moreover, given EU legislative timelines, a revised EU ETS Directive is only likely to enter into force in the last few years of Phase 3 of the EU ETS. A change to the 2020 target in 2016 or 2017 may be politically difficult, should other countries not have committed to a similar level of GHG emission reduction when negotiating an international agreement at the UNFCCC.

Conversely, a binding 2030 target, for the whole EU economy and thus the EU ETS, which is consistent with the 2050 vision, would be more realistically achievable than trying to amend the 2020 one. Agreeing a binding and consistent 2030 target would provide a clear guidance for market operators and the needed visibility for investors, on the direction in which the EU is heading towards.

In order to drive the debate forward, we would prefer the proposal to focus on a 2030 target, whilst keeping the current conditional target for 2020, if other countries follow suit. IETA calls for a clear reduction pathway coherent with scientific recommendations and based on the EU's environmental ambition.



**Conclusion: IETA does not believe a new 2020 target should be the primary focus and calls for a binding 2030 target consistent with the long-term decarbonisation pathway.**

### **Option b – Retiring a number of allowances in Phase 3**

Once the EU has agreed on a 2030 target in line with the 2050 ambition, policy makers need to decide what to do between now and 2030. One of the options put forward in the Carbon Market Report is to retire part of the surplus of allowances in Phase 3.

This proposal, also referred to as the “set aside”, is the only measure in the Carbon Market Report that we understand could be put forward early, without requiring a full review of the entire EU ETS Directive. IETA does not consider this proposal to be a structural measure, but an exceptional intervention that follows on from the backloading of allowances, and which aims to prevent the surplus of allowances from re-entering the market (i.e. with a view to avoid oversupply of allowances).

As a matter of principle, IETA does not support ad hoc interventions in the scheme, as this increases regulatory risks. Instead, a fully-fledged structural reform, aimed at addressing the root-causes of the problems should be favoured.

Should the timely adoption of other measures look challenging, then the set-aside proposal could be considered, provided it can be demonstrated that the viability of the scheme would be at risk until more structural measures are implemented. This could for instance be the case if the level of Phase 3 supply imbalance put the functioning of the carbon market at risk (which could be assessed based on the evolution of market liquidity, bid/offer spreads and/or efficiency of auctions).

**Conclusion: Withholding a certain volume of Phase 3 allowances as a standalone measure is not IETA’s preferred option. It may be justified if real structural reforms cannot be decided and implemented soon enough and if the EU ETS is in danger of failing.**

### **Option c – Early revision of the annual linear reduction factor**

Option c of the Carbon Market Report suggests revising the annual linear reduction factor of -1.74% compared to the average of emissions in the period 2008-2012.

IETA believes the linear reduction factor is a useful tool for reaching a pre-defined target. Hence, if the 2030 target is amended, to be made consistent with the restated long-term 2050 vision, we believe the annual linear reduction factor and the total cap





need to be changed accordingly. The decision to change the annual linear reduction factor should be taken before the end of Phase 3 in order to provide maximum predictability and enable proper transition planning.

The table below highlights some of the arguments for implementing an increase in the annual linear reduction factor before the end of 2020 versus those for doing so in phase 4 (but with a decision taken as soon as possible)

**Table 1 – Possible consequences of changing the linear reduction factor before/after 2020**

<b>Change linear reduction factor before 2020</b>	<b>Change linear reduction factor after 2020</b>
<ul style="list-style-type: none"><li>• Encourages investments in low carbon technology earlier on, which reduces the risk of a costly technological carbon lock-in</li><li>• Changing the factor before 2020 may alleviate the need to permanently retire Phase 3 allowances as a specific measure (if it were deemed necessary).</li><li>• Reduces the risks of market failure as the ability of market operators to anticipate future scarcity allowed by banking through “cash and carry” is not unlimited</li></ul>	<ul style="list-style-type: none"><li>• Greater regulatory stability for market operators compared to a change before 2020, who will anyway plan in advance for a tighter reduction of the cap in Phase 4</li><li>• Continuation of the allowance price signal between Phase 3 and Phase 4 through unlimited banking flexibility will align constantly emission reduction burden pre- and post-2020.</li><li>• A transition period is likely to be necessary after the legislative change is decided and before the linear reduction factor is modified. It may be too short if the factor changes before 2020.</li><li>• Reduces the risk of deteriorating the level playing field until 2020 for sectors exposed to international competition</li></ul>

**Conclusion: If the 2030 target is amended, adjusting the linear reduction factor is essential. Nevertheless such adjustment should be properly planned, avoiding market shocks and allowing investors to properly react to changes in the level of ambition.**

**The decision should be taken early enough to prevent any high carbon lock-in and place EU ETS sectors on the most efficient reduction path.**



## **Option d – Extension of the scope of the EU ETS to other sectors**

IETA believes emissions trading can generally reduce GHG emissions cost-effectively. We thus welcome the possibility to review non-ETS sectors and gases, to which the EU ETS could potentially apply.

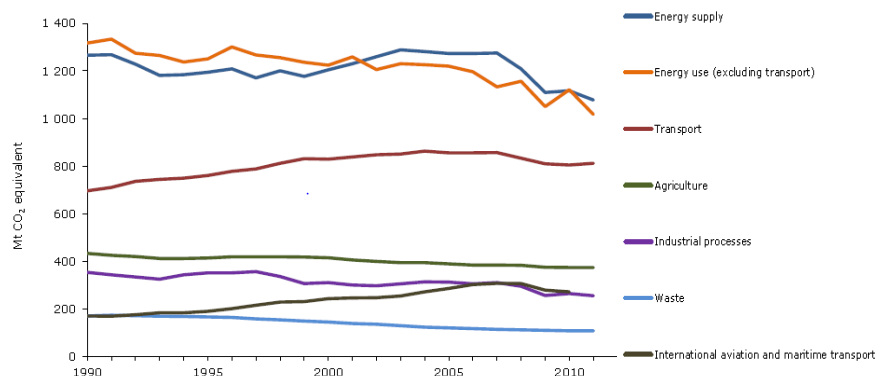
*Article 24 Procedures for unilateral inclusion of additional activities and gases already allows the scope of the EU ETS to be extended.*

The theoretical benefit of increasing the scope of the EU ETS is to make the scheme more efficient. However, this presumes that other policies and measures are not applicable to the newly included sectors. We recognize that in some sectors, other policies have been implemented and have played an important role in decreasing emissions. We would support the Commission’s intention to expand the scope, but any proposed expansion must depend on the outcome of an impact assessment on the sectors and gases that the scheme would be expanded to cover.

Inclusion of additional gases in the scope of the EU ETS with a higher Greenhouse Gas Warming Potential than CO<sub>2</sub> has already started positively with N<sub>2</sub>O from certain industrial processes and may be further considered. However, IETA believes the biggest challenge is to ensure reliable monitoring, reporting and verification of these emissions, and that other policy measures may already be more effective.

**Figure 1 – GHG emissions’ trends and projections by sector**

### **1990–2011: GHG trends & projections emissions by sector**



Source EEA 2012: Greenhouse gas emission trends and projections in Europe 2012 - Tracking progress towards Kyoto and 2020 targets

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The extension of the scope to new sectors should be evaluated according to the cost opportunity of inclusion in the ETS compared to other policy instruments and on the basis of double regulation. If the EU ETS is considered a more effective scheme, then other policy tools such as taxation, should be cancelled. Other considerations should be identified, such as the effect of other policy instruments for that sector (e.g. direct regulation, setting of standards, etc.). It should also be clarified where in the value chain emissions should be calculated, and the extent to which small sources of emissions will be required to monitor emissions. For instance, consideration should be given about whether a large number of individual sources of emissions is likely to give rise to big Monitoring, Reporting and Verification (MRV) costs for small actors, or whether these MRV requirements may not be particularly burdensome if they are already required as part of alternative policy instruments.

The following table identifies some of the advantages and challenges of broadening the scope of the EU ETS to new sectors.

**Table 2 - Advantages/challenges of broadening the scope of the EU ETS**

Pros	Cons
<ul style="list-style-type: none"> <li>• Ensures equal treatment of different energy uses enabling effective fuel shift</li> <li>• Greater coverage of the scheme and may insulate the scheme against sector specific economic cycles</li> <li>• Uniform legislation at EU level</li> <li>• Provides a pan EU consistency on the environmental outcome as a higher share of emissions is placed under the cap</li> </ul>	<ul style="list-style-type: none"> <li>• Placing the compliance obligation upstream on operators not in control of the emission sources may not be optimal to trigger reductions in GHG</li> <li>• Possible difficulties in implementation, double regulation as most potential EU ETS sectors already have a range of specific measures.</li> <li>• Increased administrative burden for smaller installations</li> </ul>

A change in the scope of the EU ETS would also impact the target for sectors covered by the scheme. Extension of the scope would require a change in the total cap of allowances, which would need to reflect the right level of emissions corresponding to the sectors covered. This option therefore also has broader consequences that need further analysis. Although IETA endorses the intention of broadening the scope of the EU ETS, this decision is likely to be taken in the medium to long-term when there is



evidence that inclusion of a particular sector or a particular gas in the EU ETS will have greater benefits than other policy instruments. As a practical matter, we do not see this option as likely to go forward during Phase 3, but may be relevant during Phase 4 of the EU ETS or depending on the discussions going on regarding linking with other emissions-trading-schemes globally.

**Conclusion: IETA supports the principle of extending the scope of the EU ETS because of the potential benefit of economic efficiency with a broader coverage of the scheme. 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 how issues of double regulation would be addressed. In addition, there are considerable practical issues for MRV on many non CO<sub>2</sub> gases and for including sectors that have millions of individual sources, which, under current EU ETS rules, would be either exempt or opted out. Finally the dynamic of the EU ETS would change as the scheme changes from a downstream (emitter-based) scheme further upstream where the regulated entities may have no direct control over final emissions. These issues rule out any action being taken in the near-term.**

#### **Option e – Limit access to international credits**

IETA does not fully understand the practical effect of this proposal: 75% of the quantitative limits for the use of international credits – estimated to be around 1.7 billion tCO<sub>2</sub>e cumulatively over 2008-2020 – are likely to be largely surrendered as soon as April 2013. Further limiting access to international credits, be it through qualitative or quantitative restrictions, would therefore have very limited practical impact on the supply of credits for the EU ETS, which has already dried up due to existing quantitative limits.

Furthermore, IETA opposes further restrictions on offsets. The EU ETS should aspire to finding ways to reduce emissions at lower costs and therefore to allow use of credits relating to emission reduction projects in third countries that can contribute greatly to cost-efficiency. Any decision on the level of international credits use should balance (i) the benefits of reduced compliance costs for operators and of the diffusion of a carbon price signal in third countries, and (ii) the minimum level of domestic abatement required to keep the EU on the most cost-efficient decarbonisation path (in line with the 2030 and 2050 target).

#### **❖ *Why and how was access to international credits allowed?***

Access to international credits was originally introduced as a principle of moving towards a global market, and the possibility of linking schemes with one another. Using



international credits is a way to increase the cost-effectiveness of reducing GHG emissions, but also an important measure to stimulate market interest in emission reductions in third countries, outside the EU.

The possibility to generate credits from third countries has allowed technology transfers to developing countries promoting mitigation efforts at local level and has strengthened cooperation among different countries. The use of these credits and the development of such projects have triggered the active engagement of different actors: compliance businesses, project developers, financial institutions, technology companies, etc.

Flexibility has a key role also in fostering developing countries' will to agree on binding commitments post-2020, since it promotes linkages among regional mitigation schemes and offers important opportunities for additional foreign investments.

❖ *What changed and what we would be expecting from access to international credits today?*

Different types of credits exist today and correspond to either offsets or Net Emission Reductions. Project-based credits as well as sectoral credits are likely to be the main two types in the future.

❖ *What options should be considered?*

The EU needs to decide whether it wants to limit access of certain credits relating to emission reductions that took place outside the EU. Such a decision is likely to be dependant on the international climate agreement that is to be negotiated in 2015. Allowing credits from countries with similar emission reduction ambitions than the EU would help develop a truly global emissions-trading market. If the EU decides to limit further eligible credits within the EU ETS according to their geographic origin, this will be a way of prioritising certain credits from emission reductions over others.

A way forward could be for the European Commission to set two targets: one for domestic reductions and a higher target that would take account of international credits. Such a differentiation of targets – similar to what is implemented both in California and in Australia – would be a way to ensure a minimum level of investment is conducted inside the EU.

❖ *What criteria should be chosen?*

Differentiating emission reductions according to where they took place should not be the direction for the EU ETS to head towards. The focus should instead be on ensuring that emission reductions are additional, or that linkages are made with similarly stringent trading schemes in other countries.



Determining which types of credits the EU wants to allow in the EU ETS could be classified according to their market value or their environmental value. The Commission could elaborate criteria to determine the types of credits that will be accepted inside the EU market.

- ❖ *Interplay between international credits, Member State auction revenues and free allocation.*

If use of international credits were to be brought under the cap, installations would receive less free allocation as compensation for carbon leakage and Member States' auctioning would be reduced. While this was not an issue in Phases 1 & 2 due to the lower levels of auctioning, more free allocation as well as the import of international offsets being outside the cap, IETA recognises in Phase 3 the dynamics have altered. Offsets need to be able to demonstrate sufficient benefits to persuade Member States and installations eligible for free allocation to forgo auction revenues and increased costs of compliance.

- ❖ *Use of international credits under a safety valve mechanism*

Turning international credits into a marginal instrument for the EU ETS, as presented in the Carbon Market Report, would (i) considerably reduce the international traction of the EU by offering only very limited initial import capacity and (ii) create risks of rocketing shocks in the international market each time the EU import limit is modified.

The existence of an international price for carbon, created by the possibility to import international credits into the EU ETS, has helped encourage developing countries to engage in curbing their emissions. The concept of a safety valve mechanism regulating the inflow of international credits into the EU ETS would create uncertainty that would disincentivise those countries to further engage in market-based climate change policies.

When triggered under a safety valve mechanism, additional import volumes of new international credits would collide with the relatively small volume authorised and impact severely their price signal in the EU ETS. Installations will not be able to plan cost effective strategies for their cost mitigation.

**Conclusion: The proposal put forward in the Carbon Market Report needs clarification, as it simply links the limit of international credits to the problem of oversupply when other factors have also played a part. This link is no longer valid due to quantitative limits already in place. Considerations that are likely to influence the decision of whether or not to further limit certain types of credits are linked to the EU's overall ambition, the EU's domestic decarbonisation path, and the geopolitics and stringency of the global agreement. Quantitative and qualitative access to international credits**



**has extensive policy implications – both domestic and international – and informed decisions can only be taken looking at the bigger picture. Marginalising international credits to a role as a safety valve is detrimental to the emission reduction objective that forms the root of the EU ETS.**

### **Option f – Discretionary price management mechanisms**

The driver for investing in low-carbon technology under the EU ETS is not based on price levels, but is based on scarcity of allowances. The current lack of foreseeable scarcity is creating a risk of potentially chronic underinvestment in low carbon technology.

Concepts discussed under option f introduce some possibly fundamental changes in the EU ETS' design to help mitigate that risk. In essence, it is about allowing allowance supply to be disconnected, under certain conditions and according to predefined rules, from the time distribution of the cap set ex-ante by policy makers.

**IETA believes that such mechanisms should, under no circumstance, be discretionary in nature or aim for a specific price outcome.**

That section of the report – both its title and substance – is unfortunately not conducive to an objective and well-informed debate on this potentially important reform area. Instead, introducing some flexibility into the scheme – under a quantity-based approach – should be further explored.

### **Absolute auction reserve price:**

IETA believes that as a matter of principle, a market-based emissions-trading scheme such as the EU ETS should operate as a quantity-based mechanism, and the goal should focus on the environmental goal - not a specific price.

*Pros:* The main advantage of setting an auction reserve price is that it is an efficient way of mitigating effects of short-term shocks; it is simple and predictable, and allows the secondary carbon market price to go down if fundamentals so require (unlike a price floor).

*Cons:* Targeting a particular price of CO<sub>2</sub> imposes an inefficiency on the market. It is the wrong approach to encourage investments in low-carbon technologies. Targeting a certain price level risks reaching the environmental objective more expensively. Conversely, it has little effect, if the level is set too low. Should a particular pricing level become a goal in itself, then it begins to resemble a tax. IETA believes a carbon tax is not



the most cost-effective way of achieving an environmental outcome for EU ETS sectors. Moreover, discussions on a minimum reserve price or a carbon tax at the EU level are unlikely to get political or industry support, let alone consensus.

By steering the policy discussions towards what the right price levels should be, we would diminish sharply what markets do best i.e. price discovery, and run the risk of seeing new national schemes emerge that seek to put a minimum price on carbon in an uncoordinated manner. Such prospect is worrying for the cost-effectiveness and the credibility of the EU ETS.

This option brings other challenges: it affects only auctioned volumes, whilst the source of historic oversupply may come from allowances allocated for free not used due to the recession or from the use of CERs and ERUs. It risks creating challenges for linking with other schemes with no reserve price (as evidenced by the Australian decision to remove its floor price when the EU-Australia linking plan was announced).

**Conclusion: IETA fundamentally opposes price-driven discussions. We share some concerns raised in the Carbon Market Report, but believe that introducing a reserve price in the current circumstances is inefficient and neither politically nor practically achievable.**

#### **Allowance reserve:**

The concept of setting up an allowance reserve is incorrectly grouped as a price adjustment mechanism. The principle of this option is that it is not driven by price objectives i.e., it is not a “price management reserve” but a “supply response reserve”. Ideally, an ambitious and binding target should be the driver for achieving emission reductions in the most cost-effective way. But we recently saw that the effectiveness of the EU ETS was also linked to external aspects, such as the level of economic activity or overlapping policies. Due to the fixed supply of the scheme, any change in levels of demand is not reflected by a comparative change in supply.

**IETA would like the Commission to consider the idea of setting up a flexible supply mechanism, whereby the rules for adjusting the supply of allowances would be determined in advance.**

*Cons:* Such a mechanism complicates the scheme, and greater detail for the functioning of the mechanism and clear rules for the future need to be correctly framed in the present. Moreover the current governance of the EU ETS is not adapted for introducing a supply response reserve.





*Pros:* This proposal would allow a supply response in the carbon market as in any other market; it would also play a role in reducing the temptation to review policy objectives in response to such shocks, as is currently the case and which is highly detrimental to investment. IETA believes that clear rules could be set as part of the structural reform of the EU ETS, to ensure ad hoc interventions in the scheme are avoided each time external circumstances change.

**Conclusion: Further consideration is needed to assess the potential benefits of this option against the design, implementation and governance challenges it raises. The Commission cannot afford to dismiss this mechanism simply by considering it as a discretionary price management instrument.**

#### **4. What additional measures should be considered in a review of the EU ETS?**

IETA's membership welcomes the start of the debate on structural measures that should be introduced in the EU ETS, but believes that options outlined in the report are not explicitly linked to a clear process of decisions on a post-2020 framework and do not provide an exhaustive view on feasible options, particularly regarding the rigidity of supply. We recognize the necessity of prioritizing certain options, and the possibility to combine some of those presented but as this is the early start of the debate, we feel that additional suggestions should be looked into. Moreover, 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 & climate policy, it must be integrated into the discussions on post-2020.

#### **Governance considerations**

A comparison of the different institutional set-up between the EU and Australia highlights some of the changes that IETA's membership would hope to see in the EU. The Australian ETS is managed by different institutions, which are responsible for different aspects of the scheme. There is a clear separation of responsibilities between the Clean Energy Regulator, responsible for the administration of the scheme; the Climate Change Authority which tracks progress, reviews and makes recommendations on environmental considerations, and the Productivity Commission, which looks at the consequences of the scheme on issues such as competitiveness and jobs. Changes to the overall cap of allowances can be recommended by the Climate Change Authority for instance, though the Australian Government has the final say on implementation. The EU currently doesn't have such differentiation and most of the responsibilities rest with the European Commission. IETA believes greater clarity on the different roles between and within the different Directorate Generals of the European Commission, would be very useful to improve the efficiency of the scheme. Greater delineation of roles related



to the administration and implementation of the scheme, would be helpful in order to have greater clarity on how/by whom policy changes can be proposed.

Moreover, IETA is worried about the increase in ad-hoc changes to the rules of the EU ETS proposed in the recent months. The delays and lack of clarity on the backloading proposals have made the market more sensitive and volatile. The ‘stop the clock’ proposal and restrictions on ERUs are other examples of sudden changes in the rules, which caused difficulties for market operators and raised questions about the efficiency of the scheme.

### **Output-based allocation of allowances**

IETA supports achieving ambitious environmental objectives through the EU ETS, but recognizes that some sectors are at risk of carbon leakage due to competition from third countries without similar levels of environmental regulation. Free allocation of allowances is an important tool that should be maintained in the EU ETS. Alternatives such as Border Adjustment Mechanisms are politically divisive and difficult to implement. We would advocate for the continuation of the free allocation of allowances based on sector-specific benchmarks, but we would like the European Commission to consider a revised allocation method.

Free allowances are allocated to sectors at risk of carbon leakage based on historical activity levels during a period of economic growth (2005-2010). As a consequence, free allocation is based on historical activity levels disconnected – in some sectors – from actual levels.

The economic downturn (that was not foreseen at the time of the benchmark decision) resulted in over-allocations across some sectors, which, combined with an oversupply of offsets and emissions reductions due to energy efficiency and renewable policy measures, has resulted in the current lower prices reflecting reduced demand. And in the light of the economic outlook for Europe, this brings a limited incentive for companies to improve carbon efficiency, and if not changed, could yield to yet more over-allocation of free allowances (or if the economy grows an under-allocation). Additionally since activity up to 50% of historic levels can currently be cut without loss of free allowances, genuine carbon leakage protection is potentially weakened. Although sharp changes in production – beyond 50% of historic levels – will result in less free allocation to the installation, there will be no change in the overall cap.

Conversely, in periods of economic development, the use of historical activity levels render any output above these levels uncompetitive due to full marginal costs and could serve as a growth disabler.



It is rational to consider a change in the allocation method to base the level of free allocation on verified production data, rather than on historical production levels that do not reflect current or future conditions.

Should actual activity levels be the reference for benchmark-based free allocation, allowances not allocated to those installations experiencing a lower output would be put into a reserve; and allowances could be drawn from that reserve to increase the volume of free allocation in cases of higher industrial activity. The mechanism would need to ensure that the average free allocations over a pre-defined number of years does not exceed the cap in periods of economic growth, or that appropriate measures would be in place to ensure that the environmental integrity of the cap is maintained.

The extension to closed and partially closed plants of the existing adjustment for opted out installations<sup>2</sup>, with unallocated allowances held in the New Entrant Reserve, could serve as a first stage in implementing the above mechanism.

Finally, it should be noted that output based allocation for sectors without product benchmarks may not be appropriate.

### **Mechanisms to manage interactions with complementary policy tools**

As highlighted in the introduction to this paper, it is necessary to prevent other policy mechanisms from undermining the reduction signal provided by the EU ETS. Options that could be considered in that regard obviously depend on the structure of the 2030 Climate and Energy package.

### **The 'do nothing' option**

This option could be considered in the analysis as a baseline tool to ensure that the market impact and disruption of any proposed change is directionally beneficial.

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<sup>2</sup> Article 9a - Adjustment of the Community-wide quantity of allowances section 4



## **Conclusion**

**IETA welcomes the publication of the Carbon Market Report and of the consultation with stakeholders, which represent an important and useful start of the debate on the future of the EU ETS. We believe that a full reform of the EU ETS should consider more than the six options included in the Carbon Market Report. Some issues highlighted in the report need to be examined in a wider context linked to discussions on a 2030 Climate and Energy Package.**

**IETA looks forward to working with the Commission over the next few months and to contribute to the debate regarding those options that need further analysis.**

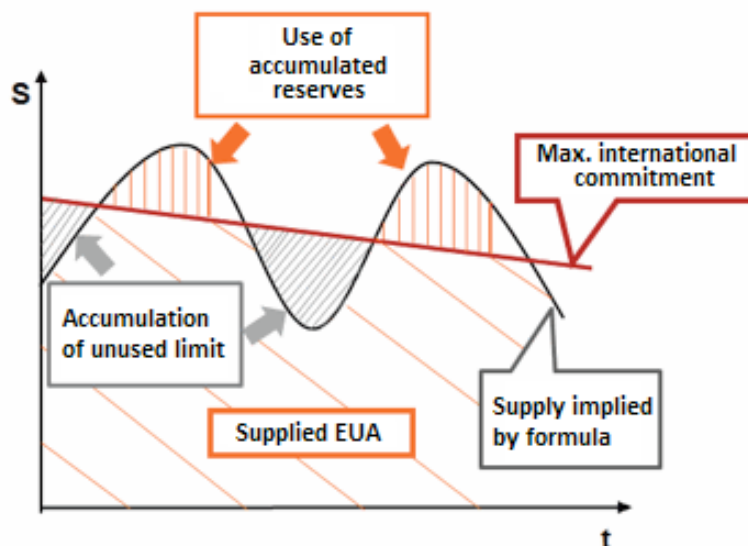


## Annexe - Possible design options of a flexible supply mechanism

We would like the European Commission to reconsider its option f, under a quantity-based perspective, and to avoid linking the idea of flexible supply with one of price management. It would be helpful to have an analysis on the possibility and feasibility of adjusting the supply, based on a transparent and clear formula, according to which allowances would enter into a reserve when the level of demand drops below a certain threshold, and/or when the level of cumulative supply exceeds a certain threshold. This would ensure a better balance of supply and demand in cases when demand either exceeds or goes below a certain threshold.

Such a scheme would ensure that the system's planned level of scarcity is maintained: in times of economic crisis, excess supply could be transferred into a reserve, from which the allowances would be released in times of economic growth. The total cap of allowances would not be modified, but it would simply allow for some flexibility in cases of strong economic recession or growth. The rules for withdrawing allowances into a reserve with the possibility of later gradual re-injection can be as restrictive as policy makers want them to be (but they must be clearly defined so as to provide transparency to the market). It is possible for instance to consider a flexible supply mechanism that would only be used in cases of extreme circumstances. Clarifying the rules for changes in the levels of supply of allowances in a clear and transparent way would ensure that we are not faced with a political debate each time external conditions change. Such a mechanism could combine the need for predictability for market operators, as the rules would be set in advance, with the need for flexibility of the scheme to adapt to external circumstances.

**Graph 1 – Schematic design of a flexible supply mechanism**





The introduction of such flexibility would consist in determining a certain threshold of surplus allowances (e.g. 1Gt), which would trigger a reduced amount of the yearly auction volume at a pre-set rate (e.g. 200m) and for as long as oversupply remains above the threshold. The amount put in the reserve would be reintroduced for auction at a pre-set rate (e.g. 200m) when the surplus of allowances falls below another threshold since a certain level of surplus is needed to enable hedging and inter-temporal balance.

The main difficulty with this proposal is to identify the formula, to determine (i) the threshold for determining when supply-demand imbalance becomes too high and (ii) how that supply/demand ratio would be calculated (e.g., ex-post or forward looking). Such a formula would need to be determined in advance, and be made public in order to ensure predictability and transparency for market operators. Such a formula should be designed so as to prevent any political pressure, guaranteeing consistency with the overarching goal of achieving the long-term 2050 and mid-term 2030 targets. Further analysis is needed to look at the governance of such a mechanism. For instance, would a new body need to be set-up to manage this reserve? Who would supervise it? It is important for these rules and any new institutional set-up to be clarified in advance.

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