Focus, društvo za sonaraven razvoj
Focus Association for Sustainable Development
Pisarna/Office: Trubarjeva 50, 1000 Ljubljana, SI
Sedež/Headquaters: Maurerjeva 7, 1000 Ljubljana, SI
+386 1 515 40 80
www.focus.si
info@focus.si

Focus Association for Sustainable Development
Maurerjeva 7
SI-1000 Ljubljana
Slovenia
Transparency Register ID number: 98048278485-29

European Commission
Directorate-General Climate Action
Unit B.1 – Implementation of ETS
Avenue de Beaulieu, 24
B-1049 Bruxelles
Belgium

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Focus Association for Sustainable Development: Contribution to the European Commission's public consultation on options to strengthen the EU Emissions Trading System

Focus Association believes that structural adjustments of EU Emissions Trading Scheme (EU ETS) are necessary in order to restore confidence in the functioning of the scheme. ETS is not functioning as envisaged, carbon price is significantly weakened. As prices of coal are falling, green investments are becoming less attractive, what puts EU at risk of staying locked in a high-carbon future. Focus therefore supports European Commission's proposal to start the debate on the reform. In the next pages, we will comment on the proposed options for the reform as outlined in the European Commission's *Report on the state of the European carbon market in 2012*.

In our opinion, back-loading of allowances is just the first step and must urgently be followed by structural reform of the ETS, as delayed auctioning of allowances (that are going to be reintroduced onto the market) is not enough to resolve the oversupply of allowances and put the scheme back on track of achieving its principal objectives.

We believe that the reform should strengthen ETS performance in both, short and long-run. In our opinion, the structural measures should reform the ETS in a way that ensures delivering of the cost-efficient abatement necessary to achieve the upper end of 80-95% emissions reductions by 2050 and does not only address the problem of accumulated surplus of allowances.

In order to provide investors with a certainty that investments in innovative clean technologies and energy efficiency improvements are cost-efficient in the long-run, the scheme must deliver uninterrupted and meaningful carbon price signal. Focus also supports the adjustment of the linear reduction factor governing the ETS cap in a way that the EU stays in line with its objective to reduce emissions 80-95% by 2050.

<u>Opinion of Focus Association on the options proposed by the Commission:</u>

1. *Increasing the EU reduction target to 30% in 2020*

EU must raise its climate ambition in order to reach the cost-efficient emission reduction trajectory by 2050 and thus increase auctioning revenues and expand low-carbon investments. Hence, Focus strongly supports the increase of the EU's 2020 climate objective to 30% domestic emission reductions.

EU almost reached its 2020 climate target by now. According to a briefing *Closing the ambition gap* from Climate Action Network Europe, it is very likely that the EU will even reach 25% domestic emissions reductions by 2020 if Member States fully implement already agreed policies. Domestic climate target of 30% is therefore a realistic goal that could be reached without too much additional effort. EU should also increase its mitigation ambition in the context of global efforts to tackle climate change challenge, as parties agreed to review their targets for the second Kyoto Protocol commitment period at the last COP conference in Doha.

Increasing EU climate objective for 2020 to 30% domestic cuts should lead to additional emission reductions in both ETS and non-ETS sectors. In our opinion, moving the climate target in the ETS sector to 30% would require cancellation of emission allowances, increase of the linear emissions reduction factor or combination of both of these options (see options below). The best choice would be aligning the ETS with 30% domestic GHG cuts by 2020 and supporting the cost-efficient achievement of the upper end of EU's 2050 objective for mitigation. We therefore suggest achieving the 30% domestic climate target through permanent retirement of 2.2 billion of allowances combined with an increase of the linear reduction factor to at least 2.6%. The linear emissions reduction factor would have to be increased from 2014 on and allowances cancelled before the end of Phase III.

2. *Retiring a number of allowances in phase III*

As already stated, this option could be one of the solutions for increasing the climate target to 30% domestic emission reductions. A concrete number of allowances that are going to be permanently removed from the market was not suggest, so Focus suggest that 2.2 billion allowances should be retired in combination with an increase of linear emission reduction factor to 2,6%. Permanent withdrawal of back-loaded allowances could be the first step that should be followed by a second wave of cancellation, as cancellation of proposed back-loaded 900 million allowances will not be enough. Retirement of 1.3 billion additional credits would be needed (in addition to these 900 million) and the volume of auction allowances would need to be decreased further between 2015 and 2020, although the Commission could also decrease free allocation through 2014 review of national implementation measures.

3. *Early revision of the annual linear reduction factor*

Focus suggests accelerating the review of the linear emission reduction factor to 2014. As *The state of the European carbon market in 2012* report points out, the 1,74% linear reduction factor is not consistent with the EU's agreed long term objective of 80-95% reduction by 2050, as it leads to a just over 70% reduction by 2050. In order to put the EU on track to reach the upper end of 2050 target of 80-95% emission reductions, emission reduction trajectory in the ETS sectors should be adjusted. This would also address the surplus of allowances expected to accumulate in the system by 2020 and could prove to be an option in case no other action (or insufficient action) is taken to tackle this problem. Assuming that 2.2 billion allowances are cancelled simultaneously, early review of the linear reduction factor in 2014 would allow limiting its increase to 2.6%.

The linear reduction factor would have to be steeper than 2.6% if the correction of emission reduction trajectory is delayed beyond 2014 or if the number of retired allowances is lower than 2.2 billion in order to compensate for a delayed action. Increase of the factor should be taken into account within the post 2020 climate and energy framework in order that targets for emission reductions, RES energy and energy efficiency are mutually supportive.

4. *Extension of the scope of the EU ETS to other sectors after 2020*

We have several reservations toward expanding ETS to other sectors. It may lead to weakening of environmental standards that are already imposed on industries that are not covered by the ETS. Looking at the transport sector, the ETS is likely to be less effective in reducing emissions, increasing sustainability and boosting innovation than the existing regulations. Expanding the scope of the ETS may even impede with future linking of the EU's carbon market with other schemes worldwide.

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5. Limit access to international credits

From 2012 on, international credits have become a major driver for the build-up of the current surplus accumulated on the EU carbon market. According to the Commission, if no action is taken, offset credits could represent as much as three quarters of the expected glut of credits by 2020. In order to avoid the similar problem in ETS Phase IV and to preserve the environmental integrity of post-2020 global climate agreement, a ban on offset credits after 2020 is needed, as additional offsets post 2020 would directly undermine the second structural measure, proposed by the Commission (permanent retirement of allowances). Hence, Focus strongly supports banning of the use of offset credits in the EU ETS after 2020.

We also recommend to urgently review quality criteria of offset credits available in the EU ETS for compliance pre-2020, as using Kyoto offset credits undermines climate goals when they are from non-additional projects. According to CDM Policy Dialogue, CDM important project types (large-scale power supply and methane projects) are unlikely to be additional. Focus therefore supports banning offset credits coming from such projects, as this would undermine environmental integrity of the ETS and increase the over-supply in EU carbon market, which is already overflown. EU must also ensure to properly address decreased financial support for clean investments in developing countries and to put in place other financing mechanisms to assist developing countries in low-carbon transition.

6. Discretionary price management mechanisms

Carbon price reflects demand and supply of allowances. Change of one of these parameters should be the primary way to affect CO_2 price. Considering that cap on emissions is the fundamental feature of the ETS, guarantying that the scheme delivers on its environmental objectives and provides a robust carbon price signal, we do not support discretionary price management mechanisms.

The reason for the current malfunctioning of the ETS is the over-supply of allowances. Hence, weak carbon price signal merely reflects market's imbalance. The cap on emissions is too weak and has to be tackled to ensure that the ETS provides strong carbon price signal. As stated in *The state of the European carbon market in 2012* report, price management mechanisms would alter the nature of the scheme as a quantity-based market instrument. In our opinion, cap on emissions should remain the main tool impacting carbon price developments. It should be set up in line with the scientific requirements, however. There are also concerns that establishment of such mechanism(s) may impede with future linking of the EU's carbon market with other schemes worldwide.

Conclusions

Focus supports ETS structural reform for improving the functioning of the EU's carbon market in both, the short (2020) and long-term perspective (2050). To ensure that cost-effective abatement to reach EU's 2050 climate objective is achieved, the reform should not only address the surplus of allowances accumulated on the market, but should also correct the current emission reduction trajectory for the ETS sectors.

We believe that the ETS has an important role in post-2020 climate architecture and should be complemented by other policy instruments. Hence, Focus supports a robust post-2020 climate framework, also GHG emission reduction target, target for renewable energy and energy savings target.

Yours sincerely,

Živa Gobbo
Chairperson,
Focus Association for Sustainable Development