Enel Group response to the EC Consultation on structural options to strengthen the EU Emission Trading System

Transparency Register

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*On November 14, 2012 the European Commission published the **Carbon Market Report** analyzing the functioning of the carbon market and considering whether regulatory action is needed, according to Article 29 of the ETS Directive. The analysis focused on:*

- *The **current state of the carbon market** affected by a huge oversupply;*
- *the **back-loading option**, aimed at restoring market balance in the short-term;*
- *a list of **6 options for structural measures** to strengthen the EU ETS in the long-term.*

*Within this framework the Commission launched a **public consultation** ending February 28, to collect inputs and views from stakeholders on how to best restore the effectiveness of the EU ETS in the long-term. As the second largest power player in Europe for installed capacity, and the fourth biggest compliance operator under the EU ETS, Enel Group welcomes the consultation and wishes to provide its contribution to the debate.*

This response aims at providing Enel point of view on the current status of the carbon market, and specific recommendations on the suitability and effectiveness of the structural measures proposed by the Commission within the Carbon Market Report.

1. Key messages

Enel supports the central role of the EU ETS in the European Climate policy, reaffirming its effectiveness in delivering abatements at the lowest cost and its capacity to guarantee technology neutrality and uniform treatment to covered sectors at EU level.

Enel calls for the introduction of structural reforms and the strengthening of the EU ETS as the cornerstone of EU climate policy by ensuring the well functioning of the scheme in the short-term and enhancing its capacity to promote the investments needed for the transition towards a low-carbon economy.

Three issues are affecting the proper functioning and effectiveness of the EU ETS:

- ETS targets are not aligned with the long-term ambition (e.g. 2050 Low-Carbon Roadmap), and firm reduction targets for 2030 until 2050 are needed to provide a clear signal for planning long-term investments;
- the fixed supply schedule does not allow the scheme to adapt to short-term contingences, and has contributed to create the current huge market unbalance;
- other policy instruments, as required by the Energy and Climate Package for 2020 and implemented at national level, have overlapping effects on the ETS, beyond what officially estimated, increasing the costs incurred to achieve the same environmental results.

These issues need to be addressed through a structural revision of the EU ETS, but since reforms will likely require 2 to 3 years to be implemented, Enel Group supports back-loading to restore market balance in the short-term and sustain expectations of future reforms among market operators.

2. Enel Group's view on the current status of the carbon market

Targets misalignment

According to the current cap trajectory implied by the ETS Directive, the EU ETS sectors will achieve a 71% emission reduction by 2050 compared to 2005, missing the reduction goals recommended by the Low-Carbon Roadmap or implied in the 2°C target set at international level.

The uncertainty deriving from this mismatch negatively affects the ability of the power and other industrial sectors to deliver the needed investments, and a risk of delay would make the entire transition to a low-carbon economy more expensive.

The reduction trajectory needs to be adjusted coherently with the long-term reduction goals by revising the total cumulative supply over the 2013-2050 period. According to current provisions cumulative supply in 2050 will amount to 52 bn EUAs, while, in order to stay on the Roadmap trajectory it should be reduced to about 44 bn, equal to a reduction of more than 8 billion EUAs (see graph 1a Annex I).

This reduction on the cumulative supply has to be translated into a new rule for annual allocation. Feasible solutions can be the adoption of a steeper linear reduction factor from phase 3 or a permanent cancellation of allowances combined with a later change in the reduction factor. Different options, (see graph 1a-b annex I), should be properly assessed since they will affect in a different way market balance both in the short and long term.

At this regards, the most suitable option to put the scheme on the right trajectory and address short-term excess of supply is the combination of a permanent retirement of 900 million EUAs and the revision of the linear reduction factor post-2020 to rebalance the market in the short

term spreading the remaining effort over the long term period.

Lack of flexibility

The carbon market is currently suffering an excess of liquidity, and the prolonged economic recession further exacerbates the mismatch between demand, which is affected by the economic cycle and the rigid supply.

A supply adjustment mechanism, to be operated under clear and transparent rules, would introduce flexibility into the scheme, preserving the perception of scarcity in the market, which will enable the market to reveal the right price in line with marginal abatements costs (i.e. "price discovery").

Such mechanism would guarantee higher stability for the scheme, limiting opportunities or need for future discretionary interventions. Flexibility should be implemented according to a rule-based approach, in accordance to criteria of transparency, predictability and simplicity to enable the incorporation of expectations of supply adjustments in the behavior of market operators.

A possible supply adjustment mechanisms would imply the management of the historical excess of liquidity to maintain the cumulative surplus within a pre-defined band in order to guarantee a certain level of scarcity but also to enable hedging and inter-temporal balance.

This mechanism aims at modifying future caps based on the cumulative surplus reached by the scheme. In case cumulative supply exceeds a pre-define threshold, the cap will be reduced (trough a reduction in auction volumes) and withdrawn allowances will be put into a reserve to be later gradually re-injected into the market as soon as the surplus will be reabsorbed by the market (see graph 2.a, annex I). Such mechanism will allow to manage annual supply according to a clear and predictable rule-based approach, avoiding private and political pressures.

Another option for ex-post supply adjustment would consist in adjusting allocation to the real production introducing a sectoral emission intensity targets. Such mechanism would allow the decoupling of the decarbonization efforts with economic cycles, guaranteeing a permanent incentive for emission reduction. Nevertheless this mechanism would arise some difficulties in the definition of the intensity targets which have to be defined to be cost effective and agreed by each sector, ensuring that the total supply over the period would remain consistent with the long term reduction trajectory.

Overlapping policies

The debate on the different policy options for a structural revision of the scheme should also

assess the effects of EU ETS overlapping policies mainly in the field of renewables and energy efficiency, implemented at EU and national level, which result in the achievement of the same environmental outcomes at higher costs.

It's evident that there is a problem of policy overlap which has resulted much more challenging than what was expected when the 2020 Climate Energy package was launched. Renewable incentives and policies for energy efficiency haven't been affected by the economic crisis and delivered results highly above expectations in a short time period. Those policies, implemented at national and local level, have displaced the EU ETS, delivering emission reduction at higher costs and lowering the demand of permits on the EU ETS market. Due to the effects of overlapping policies the effectiveness of the EU ETS has been threatened and the scheme no longer has the room to play its role in emission reduction.

The scheme needs to be restated as the primary instrument to achieve EU climate goals. Other policy instruments shall be re/shaped to not interfere with the EU ETS. The introduction of different policy instruments alongside the EU ETS could be justified in presence of mitigation opportunities not properly intercepted by the scheme as too expensive or because of the presence of non-financial barriers (permitting and authorization, smart grids, transmission networks, recharge networks for e-vehicles, …).

In addition, since complementary policies will continue to have an impact on the EU ETS, such impact and related costs need to be continuously monitored to adjust the policy mix and allowances supply accordingly.

Enel Group calls for a comprehensive and EU harmonized Climate Energy policy post-2020 able to optimize the interaction among different policy instrument.

3. Comments on the back-loading option included within the Carbon Market Report

Enel shares the Commission's concerns on the current surplus on the supply-side of over 1,5 billion EUAs, expected to reach 2 billion over phase 3 and not to be absorbed by the market before 2020.

In light of this structural excess of supply, mainly driven by the economic recession, the EC proposal to modify the auction time profile to delay some auction volumes expected for the early phase 3 to the end of the period ("back-loading option") appears suitable as a short-term action to be followed by a wider revision of the scheme.

A back-loading of 900 million EUAs, would create immediate scarcity on the market and would provide time to define how to deal with withdrawn volumes in view of permanently removing or further postponing their reinjection into the market, according to long-term decisions on the ETS.

4. Comments to the 6 structural options presented in the Carbon Market Report

The following section provides comments to the six options listed by the Commission within the Carbon Market Report, highlighting those representing most suitable solutions for a structural reform of the scheme.

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

This option is not a structural revision, but rather a change in political ambition, and does not address directly the long-term performance of the scheme.

A change in the 2020 target would not provide enough time to react and plan new investments in most of the sectors covered by the EU ETS and those outside the scheme.

Furthermore the implementation of such measure would lead to a reduction pathway much more ambitious than the one recommended by the 2050 Roadmap (see graph 1a-b Annex I), within a global context characterized by a general lack of commitment.

b.) Retiring a number of allowances in phase 3, and c.) Early revision of the annual linear reduction factor

A permanent retirement of allowances would succeed in reducing part of the excess of supply, which prevents a proper functioning of the market, without affecting the long-term reduction pathway.

On the contrary, an early revision of the linear factor would affect only the long-term ambition, failing to address short-term market unbalance.

Enel welcomes the combination of those two options since they represent two sides of the same problem: a change in the linear factor from 2020, implemented alongside a permanent retirement of allowances, would be suitable to guarantee the necessary time horizon to plan long-term investments, addressing at the same time market unbalance in the short-term.

d.) Extension of the scope of the EU ETS

Sectors currently not covered by the EU ETS scheme are subject to the Effort Sharing Decision, which commits Member States to reach agreed reduction goals at national level.

An extension of the EU ETS to new sectors would imply a wide range of advantages, enabling an equal treatment among different sectors related to energy uses, promoting economy-wide

fuel shift, encouraging the completion of the EU internal energy market leveling the playfield and contributing in achieving a higher stabilization of the scheme.

Nevertheless, sectors' dedicated impact assessments on opportunity costs and feasibility of implementation would be appropriate.

e.) Limit access to international credits

Offsets provide important cost-containment opportunities for compliance operators, promoting worldwide technology transfers and market-based mitigation policies.

Enel Group opposes further restrictions in the use of international credits since the use of offsets represents a way to minimize compliance costs according to the principle "a ton is a ton". The use of international offsets should be rather extended alongside the increasing ambition of reduction targets up to 2030 and beyond.

Flexibility plays a central role also in shaping a post-2020 Global Agreement, fostering links among different schemes and the creation of a common umbrella for bottom up mitigation initiatives.

Furthermore, in light of a future global agreement, the access to international credits would play a central role in shaping the availability of developing countries to agree on binding commitments.

f.) Discretionary price management mechanisms

Enel Group opposes the introduction of any "discretion" in the scheme since it would create uncertainty in the market and reduce predictability for operators planning their investments.

Though a deviation from a pure cap-and-trade approach, an auction price floor - combined with a price ceiling - might benefit the scheme increasing market stability and supporting investors' confidence. Yet, we fear that the political complexity in the implementation of such option (setting a price level acceptable by all Member States; avoiding price fragmentation at EU level) might be insurmountable or make it inefficient. In fact, a price defined by political compromise will hardly turn out to be set at the optimal level, being either too low (and thus ineffective) or too high (and thus distortive).

As a consequence, a quantity-based mechanism remains our first-best choice to introduce supply-side flexibility in the scheme.

5. Concluding remarks

Reaffirming a strong political support to the ETS as the most cost-effective instrument to achieve climate targets, Enel calls for a structural reform of the scheme.

ETS targets need to be aligned with long-term objectives. An effective realignment would include a short-term permanent retirement of allowances for an immediate market rebalancing.

ETS role as the cornerstone climate policy tool needs to be reinforced, ensuring that other policies do complement and enable the achievement of the climate objectives.

A supply-demand balance is key for proper market functioning, and a quantity-based supply-side management mechanism is required to introduce a level of flexibility in the scheme and adjust annual supply to short-term contingencies.

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Enel is an International Group active in 40 countries on four continents. Among the listed utilities in Europe, Enel is the second largest by installed capacity and one of the leaders in terms of shareholders' number (1.4 million investors). The Group is also present in the top rankings of world's largest utilities by market capitalization.

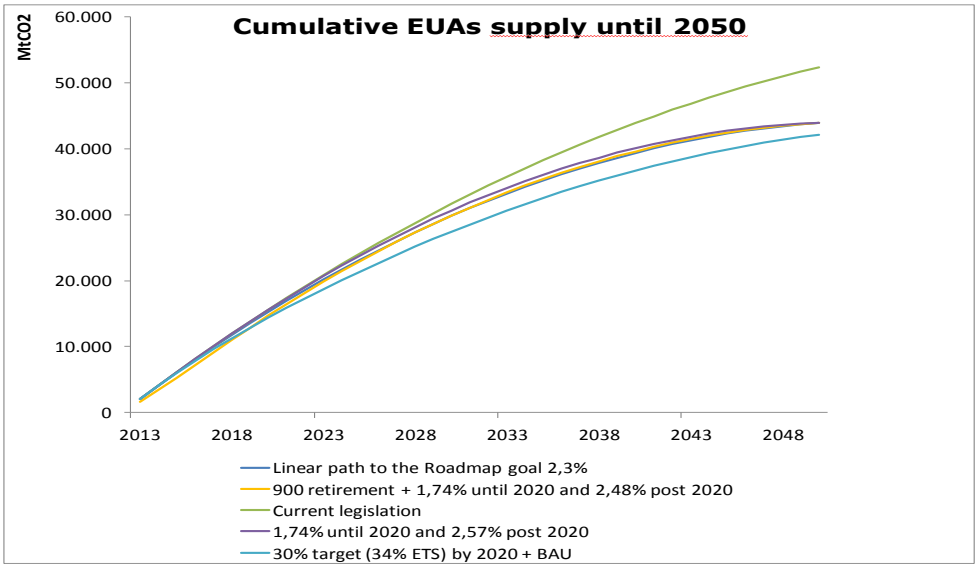
Enel generates 291.2 TWh/yr of electric power using a balanced mix of energy resources. The generation plants have a total capacity of more than 97 GW, with over a third provided by renewable sources of energy; use of the latter is increasing constantly, especially in North, Central and South America.

The Group distributes energy by 1.8 million km of power transmission lines. Moreover, Enel sells electric power to 56.8 million customers and gas to 4.5 million end users, including residential and business customers.

February 26, 2013

6. Annex I

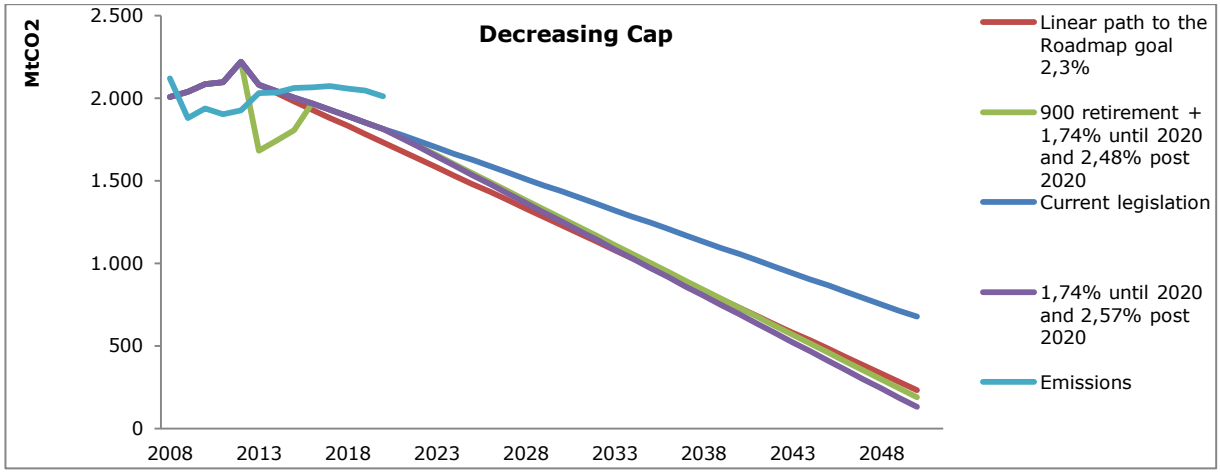
Fig.1.a



Source: Enel

Note: This graph represents the cumulative supply over the period 2013-2050 referred to different scenarios. The yellow and the purple lines represent two possible scenarios outlined by Enel to achieve the 2050 target recommended by the 2050 Low Carbon Roadmap.

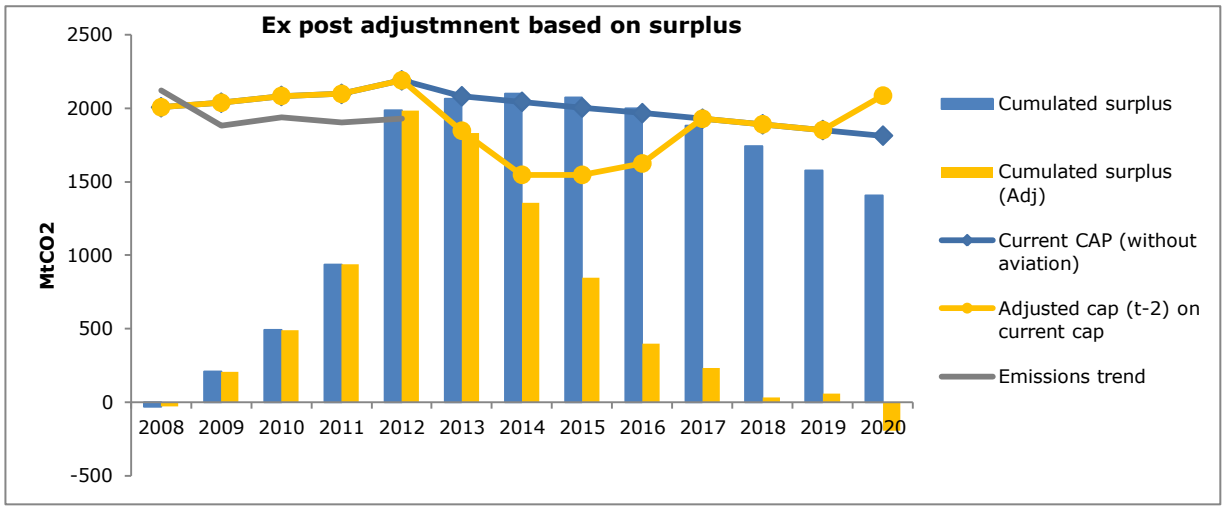
Fig. 1b



Source: Enel

Note: This graph represents the annual cap reduction trajectory according to different scenarios. The steepness of different pathways depends on the linear reduction factor applied. The light blue line represents the emission trend (ex-post data + 2020 forecasts).

Fig. 2a (Illustrative example)



Source: Enel

Note:

The graph represents a mechanism to introduce flexibility into the scheme adjusting annual supply. If the cumulative surplus exceeds a maximum threshold in year (t), a fixed percentage of that surplus will be deducted from auctions volume expected for year (t+2), thus reducing the annual cap. Retired allowances will be put into a reserve to be used to increase the cap of the year (t+2) in case of economic booms or whenever the cumulative surplus goes beyond a minimum threshold.

The blue line represents the current annual cap, to which is related the cumulative supply represented by the blue bars. The introduction of a supply-side adjustment mechanism would enable the scheme to recognize the high levels of cumulative surplus reached by the scheme in 2011and to reduce accordingly the cap of year 2013-14-15-16 (yellow line), until the cumulative surplus will be reduced to a suitable level (yellow bars). In 2018 the mechanism would recognize an extreme low level of surplus and part of previously withdrawn allowances will be automatically re-injected into the market through an increase of 2020 cap. According to this mechanism the re-injection would continue until 2030 when all the retired allowances will be reintroduced in the market.