Campaigning for an effective carbon market

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# Consultation Response (Organisation): Structural Options to Strengthen the EU Emissions Trading System

**Sandbag welcomes the Commission's first official report on the State of the EU ETS and the list of options presented for structural reform. We feel the ETS is in need of both short and long term reforms in order to be effective and environmentally adequate.**

**In the short term we advocate removing 2.2 billion allowances from Phase 3 in order to restore the levels of scarcity envisaged when the cap was set and to align the ETS with a 30% domestic EU climate target in 2020.**

**In the longer term, we recommend increasing the linear reduction factor to at least 2.52%[1] by, at the latest, 2021, in order to align the ETS cap with Europe's stated 2050 goals and establish an ambitious Phase 4 carbon budget. We also recommend introducing new rules which predictably alter the availability of both EU allowances and offsets in order to maintain incentives within the scheme and to maintain an appropriate balance between domestic and international effort.**

## The case for structural reform

Some stakeholder's interpret the EU ETS merely as a backstop policy that ensures that emissions from certain sectors of the economy do not exceed a politically pre-defined level en route to Europe's 2020 climate goal. These stakeholders tend to argue that no intervention in the EU ETS is merited unless the 2020 target is increased. We disagree.

As we interpret it, the EU ETS was supposed to be the backbone of European climate policy, and the principal driver of emissions reductions towards the 2020 target on the basis that it can "promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner"[2]. The supply of carbon allowances within that market was fixed at a level intended to create scarcity against business-as-usual emissions and to encourage low-carbon investment. That carbon budget was not intended to reward industrial firms for lowering their output. Neither was it intended to weaken Europe's commitments in 2020 by counting phantom abatement from oversupplied years towards that target.

If the EU ETS is to remain an active and cost-effective driver of abatement towards the current 2020 climate goals the scheme needs to be recalibrated to account for exogenous reductions in demand such as those contributed by the recession.

We note that, while the argument over environmental ambition tends to focus on Europe's climate targets in particular milestone years, it is ultimately the cumulative volume of emissions that is the key contributing factor causing climate change. In our view, both the current European climate

[1] This percentage applies the same baseline as the current linear reduction factor (i.e. the average annual Phase 2 cap adjusted for scope change). This trajectory does not include aviation emissions.
[2] Article 1 of the EU ETS Directive 2003/87/EC
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2003L0087:20090625:EN:HTML

targets and the budgets[3] set to meet them remain inadequately ambitious to keep Europe's emissions within its equitable share of the 2 degree carbon space. While we will separately argue the case for aligning the EU ETS with a higher climate target, we see clear environmental grounds for tightening the EU ETS budget within the current target.

## Countering objections to supply-side reform on the basis of carbon leakage threats

Some companies and trade associations have lobbied aggressively against any supply-side reforms of the EU ETS on the grounds that higher carbon prices will harm their competitiveness and cause carbon leakage, however Sandbag's research suggests that these claims are, in many cases, exaggerated. Manufacturer's have been awarded extensive protections against the market price of EUAs in the form of free allowances and access to international offsets. Following the recession these protections will carry even further against their reduced cumulative emissions. Our research has identified several prominent manufacturing firms that will not be required to purchase any EUAs from the market until sometime after 2020, even if their fleet of ETS installations consistently emit at their highest levels on record.[4]

This research has mainly focussed on the companies with the largest absolute Phase 2 surpluses, but we feel this is indicative of a much wider problem. Many smaller firms have even larger surpluses and offset entitlements relative to their emissions, and we note that all manufacturing sectors have accrued substantial surpluses over 2008-2011 that can potentially be banked forward to Phase 3.[5]

## Preferred options for structural reform in the short term:

### Preference 1: (Option B: Retiring a number of allowances in Phase 3)

We contend that the removal of approximately 2.2 billion allowances is urgently needed to restore the original levels of scarcity envisaged for the EU ETS and to maintain integrity and centrality of the scheme within the EU climate package.

We have used published reports from Deutsche Bank as a proxy for general expectations of scarcity both before and after the recession, and these figures have been informally corroborated in discussion with other analysts. In Figure 1 below, we contrast 2008 forecasts of business-as-usual ETS emissions made by Deutsche Bank prior to the recession (light grey) with verified emissions and new forecasts they made in 2012 (dark grey).[6] This shows that the expected volume of emissions over 2008-2020 is down some 2.2 billion tonnes from where it was when the Phase 3 caps were set, reducing anticipated demand for allowances by the corresponding volume.

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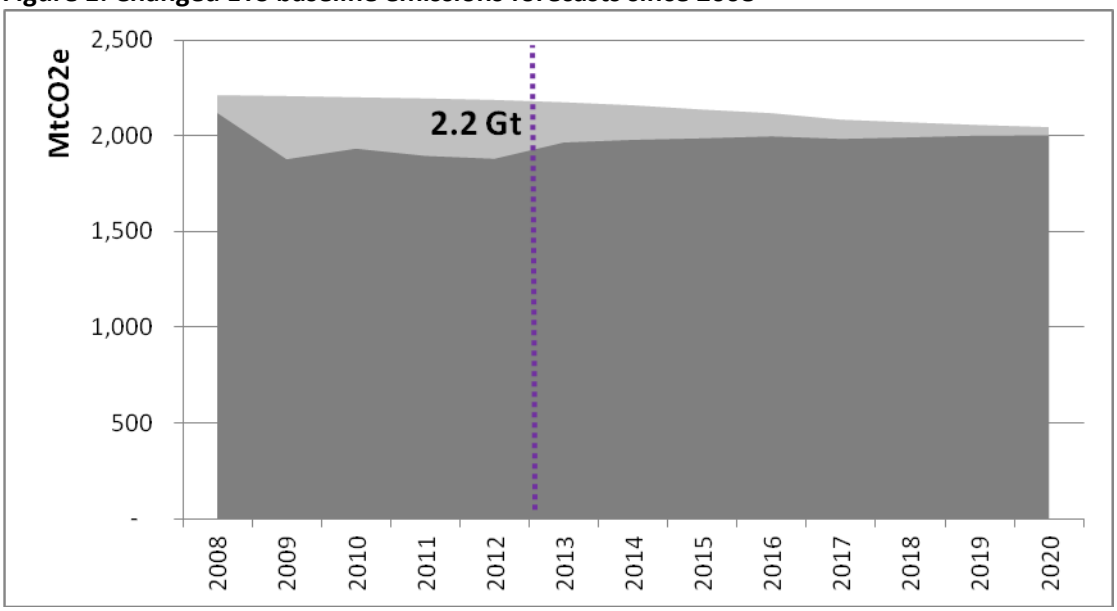
[3] Both in the EU ETS and in the Effort Sharing Decision

[4] At EU level this was found to be the case for Cementos Portland and Tata Steel (Losing the Lead July 2012); at Member State level this was found to be the case for Arcelor Mittal, Salzgitter and Hestya in Germany (Klimagoldesel 2013, February 2013); and Lafarge and Titan Cement in Greece (Carbon Fatcats in Greece, February 2013) Emissions projections assumed that by 2013 each installation in fleet returned to its peak emissions since 2005.

[5] Oil Refineries (36Mt); Coke Ovens (14Mt); Metal Ore Roasting and Sintering (33Mt); Pig Iron or Steel (285Mt); Cement, Clinker or Lime (207Mt); Glass (20Mt); Ceramics (35Mt); Pulp, Paper and Board (41Mt); Other (5Mt). As taken from the EEA ETS Data Viewer.

[6] Figures derived by comparing Deutsche Bank's 2008 report "It takes CO2 to Contango" (2008) against verified 2008-2011 emissions in CITL, 2012 emissions forecasts in "ETS Reform Should Not Be Set Aside (2012) and 2013-2020 Phase 2 scope emissions forecasts in "Scoping the Phase 3 cap" (2012).

**Figure 1: Changed ETS baseline emissions forecasts since 2008**




(Source: Deutsche Bank, EUTL and Sandbag calculations)

This reduction in demand has created a glut in the supply of European carbon allowances that will be further compounded by a flood of 1.6 billion unneeded international offset credits entering the scheme: offsets that were, again, made available under obsolete expectations about the demand for European allowances.

Assuming that policymakers had similar expectations when they established the caps, they did not intend Phase 3 to start with a legacy of banked EUAs equivalent to a year's worth of emissions. Instead, they would have expected Phase 3 to commence with minimal carryover, with the offset budget largely exhausted, and would foresee much higher emissions out to 2020 than we now anticipate.

### Preference 2: (Option A: Increasing the EU reduction target to 30% in 2020)

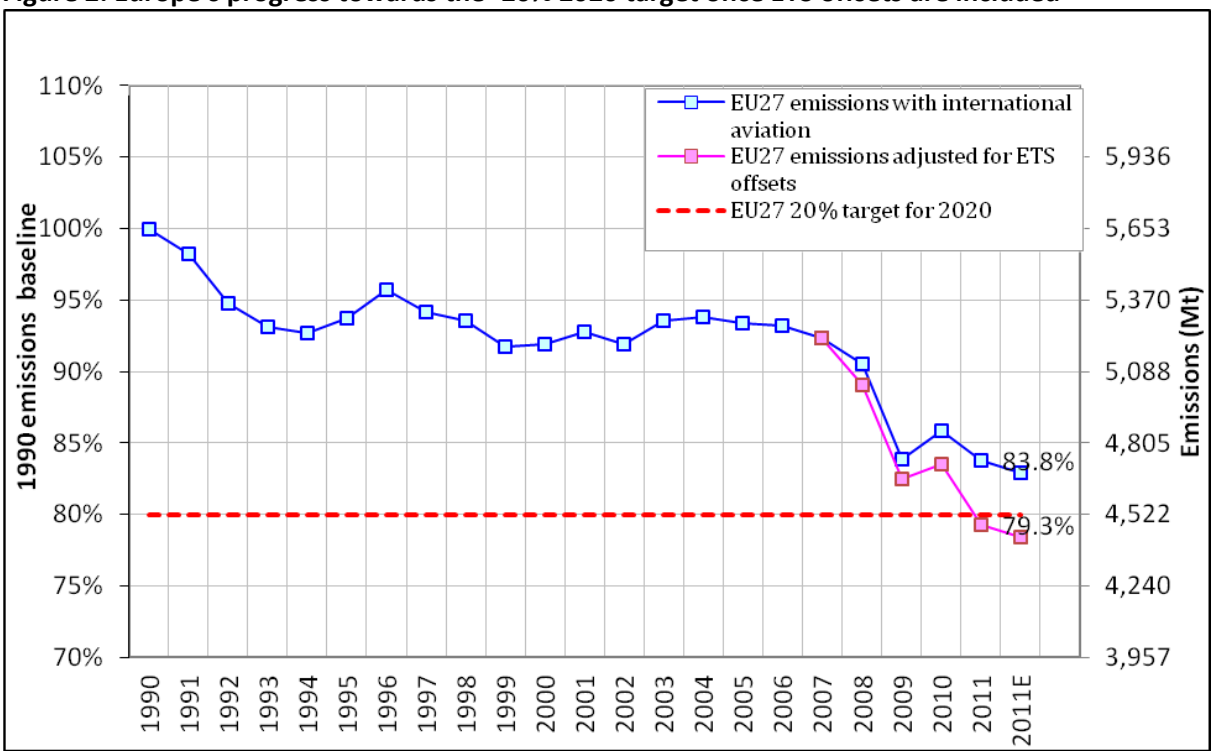
While we feel that the removal of 2.2 billion allowances is fully justified within the current 2020 target, we note that removing this quantity of allowances would be sufficient to align the EU ETS with a -30% domestic target assuming the current ratio of effort between the traded and non-traded sector is maintained.

Were Europe to cancel allowances from the EU ETS on this, or indeed any scale, we strongly recommend that this be reflected in a formal increase to Europe's 2020 climate target and its international commitments in order to leverage corresponding increases in ambition from other parties to the UNFCCC both out to 2020 and beyond.

To place the current EU climate target of -20% in context, we note that the early estimates of 2011 emissions published by the European Environment Agency place European emission at -16.2% relative to 1990 levels; however, these estimates do not account for 252Mt of offsets surrendered into the EU ETS by EU27 installations that year. If these are factored in, Europe's 2011 emissions amount to -20.7%, indicating that Europe has effectively achieved its 2020 target nine years ahead of schedule.[7]

[7] Note, that these calculations do not yet include offsets surrendered by EU governments to meet their Kyoto obligations at state level, suggesting the -20% target has been exceeded further and possibly earlier.

**Figure 2: Europe's progress towards the -20% 2020 target once ETS offsets are included**




## Preferred options for structural reform in the longer term

While the measures proposed above focus on the pre-2020 context, we make the following additional recommendations to improve the functioning and the environmental ambition of the EU ETS in the post-2020 horizon:

### Preference 3: (Option C: Early revision of the annual linear reduction factor)

We recommend policymakers bring forward the timetable to review the annual linear reduction factor with a view to implement this before 2021 in time to prescribe the Phase 4 cap. A suitably ambitious Phase 4 budget will help give the market foresight that a genuine scarcity of allowances is imminent, helping to support prices in Phase 3 and preventing unnecessary carbon lock-in.

The trajectory of the ETS should be revised so as to align with Europe's stated 2050 goals. The annual linear reduction factor of 1.74% (37.4Mt) by which the Phase 3 cap was defined extends indefinitely beyond 2020, but is currently out of keeping with Europe's long term mitigation goals of reducing emissions 80-95% against 1990 levels by 2050. This is clear from the documents accompanying the Roadmap for a Competitive Low Carbon Economy in 2050, which translate the economy-wide milestone into reductions of roughly 90% in the traded sector (relative to 2005 levels)[8]. As this figure includes emissions from aviation, which are not currently controlled by a linear reduction factor, we have used targets separately supplied for the power and industry sectors:

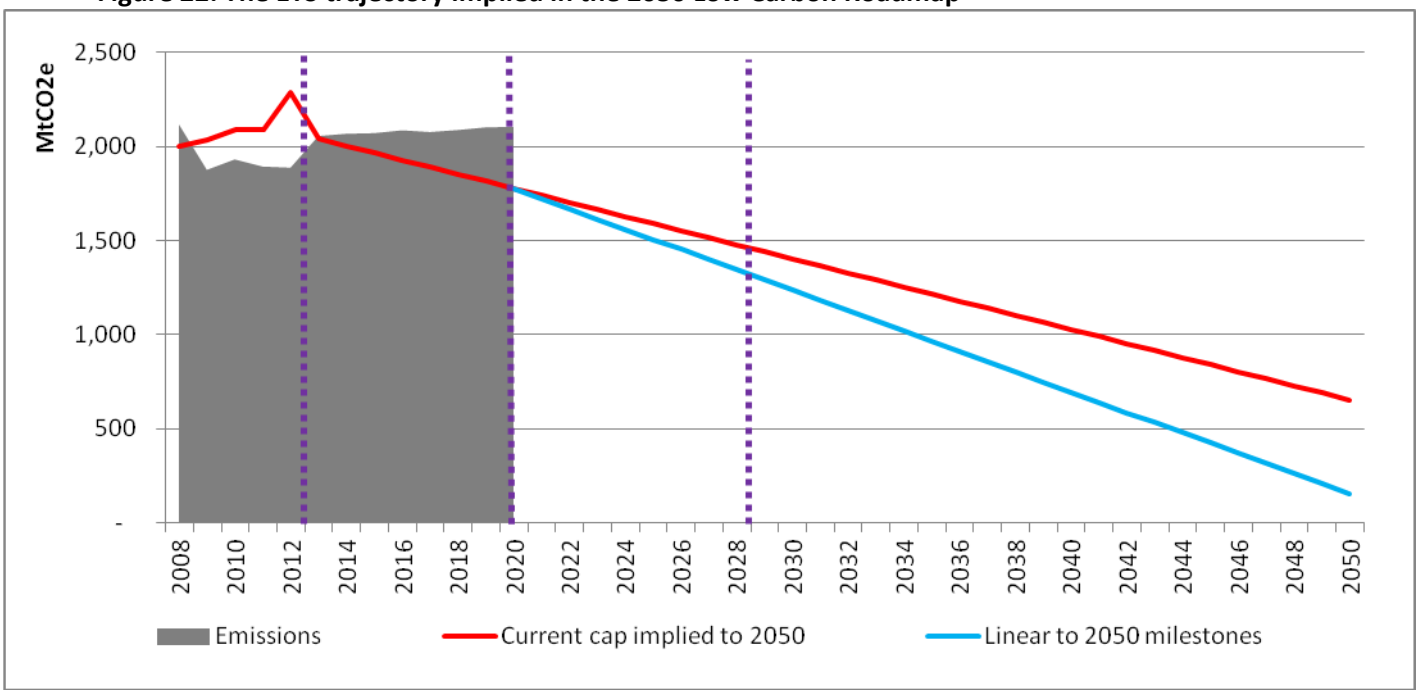
[8] Table 9 of Impact Assessment accompanying the 2050 Low Carbon Roadmap

**Table 1: Milestones for ETS relevant sectors in the 2050 Low-Carbon Roadmap**[9]

| Sector (compared to 2005 levels) | 2050 range (and midpoint) |
|---|---|
| Power emissions | -93 to -99% (-96%) |
| Industry emissions | -86% to -90% (-88%) |

These imply an aviation controlled Phase 3 scope cap 93% below 2005 levels. Reaching this target would require a linear reduction factor of at least 2.52% or (54.1Mtp.a.). This revision to the linear reduction factor would save 600Mt of emissions over Phase 4 (2021-2028) and save 7.8Gt over 2021-2050 compared with the current trajectory.

**Figure 22: The ETS trajectory implied in the 2050 Low Carbon Roadmap**




## Preference 4: (Variations on Option F: Supply management mechanisms)

The chief problems currently afflicting the EU ETS are a consequence of its unresponsiveness to massive drops in demand. This has left the scheme drowning in excess allowances and offsets which, at the moment, can only be remedied through protracted political debate and legislative change. We therefore encourage policymakers to introduce new rules which can predictably reduce the supply of allowances rapidly and automatically in order to preserve mitigation incentives in the event of future exogenous shocks.

As we have noted before, until such a time as we are confident that the Europe's carbon budgets in the ETS and the non-traded sectors of the economy keep it within its fair share of the 2 degree carbon space, any exogenous drops in demand should be capitalised on as opportunities to reduce the supply of allowances in the scheme and improve its environmental ambition.

While we generally seek to avoid adjustments to the cap based on price, in our report *Losing the Lead* we recommended two supply-management mechanisms that might help intervene on a quantity basis to preserve scarcity.

The first mechanism is designed to prevent "hot air" EUAs from one period from contaminating future periods. We proposed that auctions in each successive trading period be adjusted downward

[9] Table 1 of the Low Carbon Roadmap provides sectoral milestones against 1990 levels which we have converted to refer to the 2005 ETS baseline http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0112:FIN:EN:PDF

by a volume equivalent to the gap between verified emissions and total allowances in the preceding period. While this mechanisms also risks correcting for real abatement delivered against the preceding cap, the allowances banked forward by each individual account holder would be unchanged, and free allowances would be untouched.

While this first mechanism adjusts supply between future trading periods, we proposed a second mechanism to adjust supply within future phase. This "strategic demand-correction reserve" takes its cue from California's Voluntary Renewable Energy Reserve[10] but would operate on a larger scale. In this mechanism, a predetermined percentage of allowances are withheld from auction each year and placed in reserve for a set period (e.g. 2-3 years). If no unusual drops in emissions take place over that timeframe the allowances are returned to the market; however if exogenous demand-side reductions are identified (be they economic or policy based) this reserve will allow time for their effects to be calculated and a corresponding quantity of allowances to be permanently cancelled.

This reserve could also begin to account for voluntary emissions reductions affecting the ETS that are not yet captured by the scheme.

### Preference 5: (Option E and Option F: Discretionary Price Management Mechanisms to Limit Access to International Credits)

In addition to the responsive EUA supply controls outlined above, we would also like to see access to offsets reflect a genuine need for price containment along similarly predetermined lines. This could take the form of a price trigger that prohibits offsets from being surrendered into the EU ETS unless the EUA price passes a predetermined threshold.

Alternatively, installations surrendering offsets for ETS compliance could be obliged to pay a levy that brings the offset price up to a pre-determined level, essentially placing a price floor on offsets for ETS usage. Revenues from that levy could then be dedicated low-carbon projects within Europe.

Either of these measures could prevent the offset price from further dragging down the EUA price when this was particularly weak.

[10] See Sandbag's briefing on Californian set-aside policies for further details: http://www.sandbag.org.uk/site_media/pdfs/reports/California_set_aside_briefing.pdf