Response to European Commission Consultation on structural measures to strengthen the EU Emissions Trading System

1 March 2013

About Energy UK

Energy UK is the Trade Association for the energy industry. Energy UK has over 70 companies as members that together cover the broad range of energy providers and suppliers and include companies of all sizes working in all forms of gas and electricity supply and energy networks. Energy UK members generate more than 90% of UK electricity, provide light and heat to some 26 million homes and invested over £10 billion in the British economy in 2011.

We welcome the opportunity to comment on the options for measures to tackle the growing structural supply-demand imbalance in the EU Emissions Trading System (ETS) that the Commission has set out in its report on "The state of the European carbon market in 2012" (the Carbon Market Report), published in November 2012.

1. Key messages

- Energy UK is strongly committed to the EU ETS as the best means to achieve the European Council goal of an economy-wide 80-95% reduction in EU greenhouse gas emissions by 2050 within an integrated EU Internal Energy Market. We consider the ETS to be the best pan-European instrument to drive investments in carbon reduction because it is technology neutral, because carbon markets are the cost-effective way to drive investment choice in CO_2 reduction and because the ETS is fully compatible with the Internal Energy Market.
- We welcome the Carbon Market Report as a first step towards improving the ETS and restoring its credibility as the key policy driver for CO_2 emission reduction. However, we have a serious concern that the structural measures outlined in the report are not linked to a clear process for developing a post-2020 climate and energy policy framework. In order that the EU power sector can continue to deliver reliable, affordable and sustainable electricity, Energy UK looks to the Commission to bring forward urgently a coherent package of proposals which:

- Establishes an ambitious, firm, long-term, economy-wide greenhouse gas reduction target for 2030 up to 2050, in line with the European Council goal, as part of an EU Climate and Energy Package for 2030;
- Establishes the contribution to CO_2 reduction to be made by the ETS sectors by 2030;
- Revises the ETS annual linear reduction factor accordingly;
- If necessary, and only as part of longer term reforms, makes use of the option to retire a number of EU Allowances (EUAs) in Phase 3 in order to re-establish market confidence quickly;
- Consequently establishes the ETS as the main pan-European policy instrument for driving investment choice in CO_2 reduction;

- With regard to the options for structural measures, Energy UK gives highest priority to Option (c) for an early revision of the annual linear reduction factor in line with a 2030 target. Option (b) to retire EUAs in phase 3 is seen as subsidiary to Option (c) because it does not provide a long-term signal.
- Energy UK also firmly supports Option (d) for the extension of the scope of the ETS to other sectors because this is consistent with the goal of cost-effective, economy-wide carbon reductions and the completion of the harmonised Internal Energy Market, and we call on the Commission to undertake a detailed assessment of the feasibility of extending the scope of the ETS for Phase 4.

2. General comments on the Carbon Market Report

Energy UK broadly concurs with the Commission in its analysis of the current structural surplus of allowances in the ETS, noting that the carbon market is the only known market where there is no supply reaction to falling demand. We also agree that the current state of the market has important implications for the EU's post-2020 policy framework and for the development of an international carbon market.

Energy UK is committed to the ETS as the best pan-European instrument to drive investments in carbon reduction because it is technology-neutral, cost-effective and fully compatible with the Internal Energy Market. In calling for a whole-economy 2030 target and for a cost-effective market approach, Energy UK strongly agrees with the Commission's statement that the ETS will need to play an increased role in the transition to a low-carbon economy by 2050. We also remind EU decision-makers that, at the time of the decision in 2000 to establish the ETS, they emphasised that "a Community approach is needed to ensure competition is not distorted within the internal market" and that uncoordinated action would have significantly higher costs. With the current trend for energy and climate policies to be set at national level through the introduction of a range of support mechanisms and taxes, we see a serious risk that a non-ETS approach to de-carbonisation will not only distort, but also fragment, the Internal Energy Market.

With international negotiations in the UNFCCC proceeding slowly, showing the world that the EU remains committed to a long-term strategy of driving carbon reduction through a strong ETS is crucial to securing a global level playing field in climate action. Energy UK warmly welcomes the recent decisions in Australia, New Zealand, South Korea and China to establish domestic carbon markets on the model of the ETS, as well as the on-going preparations for linking the Australian and EU markets. Together with the EU, robust carbon markets in California, the north-east USA Regional Greenhouse Gas Initiative, Australia, New Zealand, South Korea and China can help to reduce emissions in around 40% of the world economy.

3. The role of the ETS in a 2030 Climate and Energy Package

While welcoming the Carbon Market Report as a step in the right direction, Energy UK nonetheless remains deeply concerned about design flaws and policy interactions in the current 20/20/20 Climate and Energy Package and the slow pace of current EU decision processes which will shape a future 2030 Package.

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

4. Comments on the options for structural measures

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

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

Energy UK has focused its assessment on Options (b) for retirement, (c) on the linear factor and (d) on expanding the scope of the ETS. We note that Option (a) would be implemented through either Options (b) or (c), and that Option (e) may be better considered in 2015, in light of the outcome of the UNFCCC Durban process towards an international climate change agreement. Regarding Option (f) for introducing a discretionary price management mechanism, Energy UK shares the concern that this "would alter the very nature of the current ETS being a quantity-based market instrument [so that] the carbon price may become primarily a product of administrative and political decisions (or expectations about them), rather than the interplay of market supply and demand."

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

In Energy UK's view, Option (b) for a retirement of EUAs in Phase 3 has both advantages and disadvantages. We see Option (b) as clearly subsidiary to Option (c) but also closely linked; the case for Option (b) depends on when the revised linear factor can come into effect. Certainly a one-off retirement of EUAs would be an insufficient measure on its own, because it does not provide the necessary long-term signal; on the other hand, Option (b) can have a speedy impact, re-establishing market confidence in a relatively short time, which may not be possible using Option (c) alone. Some Members would therefore favour a short-term retirement in order to rebalance supply and demand quickly. Energy UK Members agree, however, that any retirement in Phase 3 should be integrated into a subsequent revision of the linear factor in order to bring the retirement into alignment with the 2030 target; in other words, we look at Option (b) only as a means to implement Option (c). We note that a retirement would affect only auctioned EUAs, not free allocations, thereby maintaining the regulatory stability of the wider legislative ETS framework for Phase 3.

Finally, Energy UK agrees with the Commission that Option (d) to extend the scope of the ETS to other sectors is "consistent with potential energy system changes such as the increased use of electricity, gas and biomass in all energy related sectors in the transition toward a low-carbon economy by 2050". Although this option is not a short-term solution for the ETS today, it is Energy UK's preferred long-term plan for Phase 4 beyond 2020. We call on the Commission to undertake a full analysis of the feasibility of extending the sectoral scope of the ETS to e.g. transport and heating, taking note that both the Californian (from 2015) and the Australian carbon markets have a wider sectoral coverage than the ETS. Energy UK also sees a fundamental contradiction between the goal of cost-effective, whole-economy decarbonisation and any division of the current ETS into separate sectoral schemes. In order to achieve the cost-optimising benefits of a market, it is crucial that a consistent CO_2 price signal should apply throughout the economy, enabling the efficient distribution of assets. Where they are necessary, differentiated sector burdens are already included within the ETS through the mechanism of free allowance allocations, although we recognise that this will need to be reviewed beyond 2020.

While it is recognised that changes to ETS Phase 3 can only be slight revisions, future legislation for Phase 4 could clarify that the objectives of the ETS encompass delivery of the EU's CO_2 objective at least cost and driving the investments in low-carbon technologies needed to sustain those emission reductions.

5. Potential cost and economic impacts of structural measures

In order to succeed in limiting climate change, decarbonisation needs to take place throughout the whole economy – not just in the power sector. Energy UK notes that the purpose of the ETS is to expose both our sector and other sectors to external costs of carbon so that businesses invest in low-carbon innovation, and so that Europe develops next generation technologies.

With regard to compliance and administrative costs, Energy UK's primary concern is not the impact of adjustments to the ETS, but rather the expense of a non-ETS policy approach. The administration of a large number of different policy instruments is already resulting in significant additional costs to consumers.

Energy UK supports a strong ETS because we see this as an effective way to provide affordable, reliable, and sustainable energy to the EU economy.

Meanwhile, on-going policy uncertainty due to a weak ETS and the lack of a CO_2 reduction target beyond 2020 means that the European electricity sector is unattractive to investors and our sector is experiencing its own problem of global competition; instead of investing to replace old power generation plants and grids in Europe, EU-based power companies are becoming international and are investing elsewhere in the world. A stronger ETS can help to solve this problem.

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