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for Coal and Lignite
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EURACOAL Position Paper

on the "back loading" of allowance auctioning under the EU Emissions Trading Scheme (ETS)

EURACOAL Position

The Commission proposes to "back load" the Phase 3 auctioning of EU ETS allowances to ensure "an orderly functioning of the market" and claims that any such market intervention would only be made "in exceptional circumstances", such as are seen today.[1]

EURACOAL does not support the proposed amendments to the ETS Directive[2] or to the ETS Auctioning Regulation[3]. The Commission's proposal would place new burdens on EU industry at a time when the economy is already fragile. Moreover, the agreed ETS emissions reduction target for 2020 will be achieved and any market intervention now would risk discrediting the ETS as a market-based mechanism to achieve these politically agreed goals. Economic recovery should not be compromised by imposing new targets or by changing ETS rules prior to the scheduled review before 2020 and subsequent decisions by 2025.

The effort sharing decision for the EU ETS, agreed by Parliament and Council in 2009, includes a provision to promote a new international agreement on greenhouse gas (GHG) emissions reductions with similar ambition to current EU policy.[4] Following signature of such an international agreement, the EU would prepare assessment reports and proposals for a more stringent 30% GHG reduction target for 2020. Given that there is no new international agreement, EURACOAL is surprised that the Commission has been examining ways to further limit the supply of ETS allowances through "set aside". Any such restriction is clearly not in accord with the legal basis of the EU ETS and should not be supported by Member States.

On the proposed amendment to the ETS Auctioning Regulation, EURACOAL views the public consultation as flawed because the Commission's proposed amendment does not stipulate the allowance volume reductions or when these volumes would be released back into the market. Although the accompanying staff working document presents three scenarios, it is not clear which one, if any, of these scenarios is the basis of the consultation.[5]

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[1] Consultation on review of the auction time profile for the EU Emissions Trading System, DG CLIMA, 25 July 2012

[2] 2003/87/EC as amended by 2009/29/EC

[3] Commission Regulation No. 1031/2010

[4] Decision No. 406/2009/EC of the European Parliament and of the Council of 23 April 2009 on the effort of Member States to reduce their greenhouse gas emissions to meet the Community's greenhouse gas emission reduction commitments up to 2020

[5] SWD(2012) 234

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Background

In its "Roadmap for moving to a competitive low carbon economy in 2050", the European Commission refers to the "set aside" of ETS allowances during Phase 3 of the scheme (2013-2020).[6] This, the Commission says, may be necessary to maintain the carbon price incentive even when complementary actions on energy efficiency and renewable energy sources reduce demand for ETS allowances and hence drive down allowance prices.

The poor performance of the EU economy as a whole has weakened demand for ETS allowances such that allowance prices have fallen to below €7/tCO_2 during 2012, compared with over €25/tCO_2 in mid 2008. In response, various proposals have been made by the Commission and in Parliament to bolster allowance prices by cancelling allowances or delaying the auctioning of Phase 3 allowances.

EU Emissions Trading Scheme Phase 3 allowance allocation

The Commission has set the rules under which allowances will be auctioned when Phase 3 begins in 2013.3 Initially, 2,039,152,882 allowances will be issued and this number will decrease linearly each year by 1.74% of the baseline (*i.e.* 37,435,387 fewer allowances each year), according to Article 9 of the ETS Directive.[7] The initial baseline of 2,151,459,043 allowances for 2010 was calculated by aggregating the average number of allowances issued during Phase 2 under national allocation plans submitted by Member States.

"Set-Aside" and "Back Loading" Proposals

In 2010, a Commission Communication on moving beyond a 20% GHG reduction target for 2020 postulated a 15% or 1.4 billion reduction in the number of Phase 3 allowances (by increasing the annual reduction to 2.25% of the baseline).[8] More recently, on 1 February 2012, a Commission Staff Working Paper examined how to manage an equitable reduction in the number of auctioned allowances.[9] High-income Member States would reduce the number of allowances they auction by 38%. Low-income Member State governments would benefit because allowance prices would be boosted, but they would not need to reduce the number that they auctioned.

In a draft amendment to the ETS Auctioning Regulation published on 25 July 2012, the Commission proposes to delay the auctioning of 400 to 1,200 million allowances from 2013-2015 towards the end of Phase 3.[10] To ensure that it has the legal competence to enforce this regulation, the Commission

[6] COM(2011) 112/4

[7] Commission Decision 2010/634/EU, since complemented by 2011/149/EU on aviation-sector emissions

[8] COM(2010) 265

[9] SWD(2012) 5

[10] SWD(2012) 234

proposes to amend Article 1 of the ETS Directive by adding a single sentence: "The Commission shall, where appropriate, adapt the timetable for each period so as to ensure an orderly functioning of the market." There is no accompanying definition of "an orderly functioning of the market".

EURACOAL believes that the ETS allowance market has been functioning in an orderly way because prices have properly reflected allowance supply and demand. We are therefore very concerned that by "orderly" the Commission means that it wishes to exercise control over the market and effectively to set allowance prices.

In the European Parliament, the Environment Committee narrowly passed amendments on 20 December 2011 calling for 1.4 billion allowances to be cancelled and for the annual reduction to be increased to 2.25% of the baseline from 2014.[11] On 31 January 2012, compromise amendments to a non-legislative report by the Environment Committee, in response to the Commission's 2050 low-carbon roadmap called for, "recalibrating the ETS before the commencement of the third phase by setting aside a significant number of allowances so as to restore scarcity".[12] Similar calls are made in the Industry Committee's report on the Energy Efficiency Directive which were voted on by Parliament in September 2012.[13]

Those amendments would not be in line with the existing legal basis of the European Emissions Trading Scheme.[4] Article 8 of Decision No. 406/2009/EC contains provisions for assessing and making proposals for a stricter reduction of GHG emissions in the EU that go beyond the 20% target for 2020. A pre-condition is an international agreement on climate change signed by the EU that leads, by 2020, to mandatory reductions of GHG emissions exceeding 20% compared to 1990 levels. With no such international agreement in place, the legal basis of the ETS leaves no room for measures such as set aside that would tighten the EU GHG emissions reduction target for 2020.

Cancelling allowances or delaying the auctioning of allowances to a future phase would require amendments by legislative process, and would therefore create uncertainty. It could be argued that set aside is necessary to safeguard the efficiency of the scheme, as required under Article 1(5). However, the ETS Directive aims at predictability – see Article 10(4) – so the Commission would have to make timely revisions to the ETS Auctioning Regulation to ensure that the scheme continues to be viewed as a credible market-based scheme and not a scheme subject to short-term political interference.

The ETS Directive, "provides for the reductions of GHG emissions to be increased so as to contribute to the levels of reductions that are considered scientifically necessary to avoid dangerous climate change" (Article 1). Some have argued that new scientific information justifies a new decision,

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[11] rapporteur Peter LIESE, EPP, DE

[12] rapporteur Chris DAVIES, ALDE, UK

[13] A7-0265/2012 rapporteur Claude TURMES, Verts/ALE, LU

amending those that set the number of allowances issued. It is clear to EURACOAL that the scientific information has not changed in any way that could justify such an action that would, in any case, have no perceptible impact at the global level. Moreover, there has been no international agreement that would allow the Commission to move beyond the agreed 20% GHG reduction target and there is no political agreement on further unilateral action.

Achievement of Targets

Achievement of the EU's 20% GHG reduction target for 2020 can be taken as a given because of a combination of the economic downturn and massive government support for renewable energy sources. The ETS has proven to be cost-effective and economically efficient, as required by Article 1 of the ETS Directive. Indeed, it has to an extent compensated for the difficult economic situation that the EU now finds itself in by lowering the cost of carbon at a time when any additional cost burden would be unwelcome. When the ETS started in 2005, oil prices hovered around \$50/bbl. Today, oil prices are around \$115/bbl. The increase of \$65/bbl is equivalent to a carbon price of €115/tCO_2.[14] High fossil fuel prices mean that we already have a rather high implicit price for carbon, on top of the ETS allowance price.

The EU has agreed to longer-term GHG reduction targets for 2050. After Phase 3 of the ETS, it will be necessary to adapt the linear reduction to the number of emission allowances issued each year so that the ambitious 2050 targets are achieved. A decision on this should be taken as envisaged by Article 9 of the Directive which foresees a review and proposal before the end of Phase 3 in 2020 and a decision by 2025. This future review should not influence the agreed reductions for Phase 3.

Concern has been expressed about the international credibility of the ETS if carbon prices are seen to be very low and thus not acting as an incentive for investment in low-carbon technologies. EURACOAL agrees that the scheme's credibility is at risk. However, the risk comes not from low carbon prices, but from the signs of *ex post* political interference which would discredit the scheme and, more generally, from the Commission's multi-layered climate and energy policy with sometimes conflicting measures and initiatives. The ETS would function well if it were the only measure used to reduce emissions: adding energy efficiency measures and renewables support will naturally weaken the ETS.

Carbon Tax or Carbon Trading?

EURACOAL warns that any interference through the set aside of allowances or back loading of allowance auctioning will discredit the ETS. The scheme will be viewed no longer as an efficient

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[14] \$(2005)50/bbl = €40.27/bbl, \$(2012)115/bbl = €88.71/bbl. The difference of €48.44/bbl or €355.07/toe equates to a carbon price of €424.01/tC or €115.64/tCO_2, assuming a crude oil CV of 10,000 kcal/kg and an emission factor of 20 tC/TJ (*i.e.* a carbon content of 83.74%).

market-based mechanism, but as a scheme subject to political manipulation to achieve *a certain carbon price*, and not a scheme to achieve *an agreed carbon reduction*. If policymakers wish to set a certain carbon price, then the ETS is the wrong mechanism. Carbon taxation gives a predictable carbon price, but, in the EU, it has already been decided that achieving targets takes priority over price.

Moral Hazards and Corporate Dilemmas

The Commission has stated that this would be a "one-off intervention". However, it would be impossible to give the market a guarantee that there would be no future interventions. There is an obvious moral hazard that a one-off intervention is repeated by a future Commission.

Indeed, with the agreement announced on 28 August 2012 between Australia and the EU to link carbon trading schemes and a possible future agreement with China, the future potential for EU ETS allowance price volatility will increase. In such a situation, the pressures on the Commission to "fix" the ETS price would grow, but with the risk of alienating international partners. Today's proposed market interference is not a viable policy route and should be abandoned.

Many companies have "banked" allowances under Phase 2 with the intention of carrying them over to Phase 3, as allowed under Article 13(2). This creates a dilemma for some companies: should they seek a quick fix to the ETS to improve the value of their "long" positions in ETS allowances, or should they seek a stable ETS that can become the main instrument of EU climate and energy policy in the long term?

A rather clear position is seen from the oil and gas sector which says that the ETS needs tightening to raise carbon prices. Given that oil and gas consumption accounts for two-thirds of CO_2 emissions from fossil fuel consumption in the EU, this is a curious position. It makes sense only when coupled with the knowledge that fuel switching from coal to gas in the power sector is a strategic priority for the gas industry. Carbon pricing encourages such fuel switching and thus the ETS is a very effective natural gas marketing tool.

29 September 2012

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