Consultation on structural options to strengthen the EU Emissions Trading System

Response of CEZ Group

CEZ Group belongs among major power generators in the Central and South-Eastern Europe producing 65 TWh annually and operating 15.000 MW. More than half of its production comes from fossil fuels. Therefore a low carbon regulation imposed predominantly at the European level represents a key challenge for its business and further development. Since its introduction CEZ Group has been supportive to the market-driven solution represented by cap-and-trade mechanism, i.e. the EU ETS system. As stipulated in Article 1 of the ETS Directive the system has been established in order to promote reductions of greenhouse gas emissions in a cost-effective and economically efficient manner and shall be a critical driver of investments in low carbon technologies. Having built on this assumption and on the intention to bear its respective reduction burden at the least economic cost, CEZ Group has decided on and undertaken a number of investments amounting nearly 100 billion of CZK so far. However, due to long term low price of CO2 resulting from the insufficient resilience of the system to asymmetric shocks, the expected revenues based on the concept of the „early goer“ did not materialise and further planned investments are in threat. Thus timely and appropriate measures need to be taken. With full consistency with our response to the previous consultation on the back-loading issue CEZ Group once again welcomes and appreciates the opportunity to contribute to the consultation which we find very urgent and appropriate.

In the consultation document, i.e. the report from the Commission called *The state of the European carbon market in 2012,* the Commission outlines six measures. These measures might be all more or less feasible and could more or less remedy the imperfections of the current EU ETS. Having briefly analysed them and taking into account the recent development in this area, **CEZ Group is of the view, that:**

- **Retiring a number of allowances in phase 3** seems to be, in terms of feasibility, responsiveness and consistency, the first best choice. Also from the view of the underlying theory of the market driven mitigation, i.e. the ability to internalise the externalities, permanent set aside is the most promising option. Last but not least, such a timely response is essential for further realization of investments necessary for low carbon transformation.
- **Early revision of the annual linear reduction factor** is, in terms of its strengths, quite similar to the set aside measure. Moreover, it might be well in line with efforts to solve the existing discrepancy between 2020 and 2050 targets. However, as far as the efficiency and speed are concerned, it somehow lags behind the choice above and thus could be perceived as second best option or more as a complementary tool.
- **Increasing the EU reduction target to 30% in 2020** guarantees neither a quick action nor fundamental change. Such a step would definitely raise extensive political debates concerning effort sharing decision and possible progress at the international level, being for the EU an ultimate precondition to move further.
- **Discretionary price management mechanism** is the only option that to some extent contains an element of rebalancing. In reality, however, it would demand excessively increased role of the regulator, connected with the risk of information asymmetry and increase in administrative costs. Worse, it would weaken the market nature of the system and under some circumstances could act as a carbon tax. Under such settlement, the incentives to search for the most effective emission reductions would be significantly smaller compared to cap and trade.

- **Extension of the scope of the EU ETS to other sectors** or **limited access to international credits** do not represent, in our opinion, feasible and efficient solution at all. The former would be extremely difficult to negotiate, set, operate, monitor, verify and report. The latter obviously does not affect the current trading period and its existence after 2020 is highly uncertain and arguable. So are its possible impacts.

Conclusion

The current state of EU ETS calls not only for immediate recalibration but also for a fundamental change which would prevent recurrence of the imbalances in the long run. Most measures proposed by the Commission cannot per se fulfil these requirements due to either a lengthy legislative process, weak political will and/or a lack of systemic change component. They do not sufficiently eliminate the risk of asymmetric shocks and consequently the need for administrative intervention of the regulator. Therefore, we bring forward, for a kind consideration of the Commission, all the stakeholders and entities engaged, the following proposal:

- Ideal and most preferred way would be a combination of ambitious set-aside and shock absorbing measure based on flexible cap and trade system.
- **Flexible cap and trade system** lies in the introduction of the **carbon intensity targets under the current EU ETS**. It would allow the supply side to respond flexibly to the economic cycle and focus on the stable improvement of the technology while maintaining the overall emission cap. More specifically, we would fix the required carbon intensity path for the future (in terms of tons of CO_2 per MWh or tons of CO_2 per unit of industrial production) instead of absolute volumes. The supply of allowances in each period would then be the product of this pre-determined intensity and realized production (taken from public sources such as Eurostat and ENTSO-E). The rest of the system including the overall cap, industrial benchmarks, auctioning rules, etc. would remain the same.
- The modified system would be consequently perfectly robust against recessions and almost always robust against economic booms (unless the long term cap is reached). Another advantage is the neutral effect of the EED on the EU ETS as the realized savings would cause proportionally lower allocation of allowances.

CEZ Group deeply believes that its proposal which embodies only a relatively minor adding to the current design could lead to substantial enhancements of the EU ETS in terms of more stability, predictability and consistency with other EU energy policies. At the same time, such a step would not increase the overall administrative burden and it can be easily implemented.