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## EFIEES contribution to the public consultation on structural options to strengthen the EU Emissions Trading System

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EFIEES

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**EFIEES** represents private companies ensuring an overall management of energy demand to end-user (Energy Efficiency Service Companies, EESCs). These companies provide operational maintenance and management of equipment of their industrial, tertiary and residential customers (collective or individual), public and private, particularly sporting facilities, schools, and hospitals. They commit, by long-term contracts, a technical, financial, economic and environmental performance.

**EFIEES** members are directly concerned by the **EU ETS** as they are involved in the production/distribution of heat in several Member States as well as in operation of District Heating networks.

## QUESTION

Stakeholders and experts in the field of the European carbon market are invited to comment on the structural options and views reflected in the report "The state of the European carbon market in 2012", which serves as the consultation document:

- a). Increasing the EU's greenhouse gas emissions reduction target for 2020 from 20% to 30% below 1990 levels;
- b). Retiring a certain number of phase three allowances permanently;
- c). Revising the 1.74% annual reduction in the number of allowances to make it steeper;
- d). Bringing more sectors into the EU ETS;
- e). Limiting access to international credits;
- f). Introducing discretionary price management mechanisms such as a price management reserve.

Please indicate the expected impact of individual structural options, including on:

- ⇒ emission reductions;
- ⇒ ability of the EU ETS to meet the EU long-term target of an 80-95% reduction in a cost-effective manner;
- ⇒ your activities or the activities of the business under your jurisdiction, including estimated changes in compliance and administrative cost;
- ⇒ employment and households.

## ANSWER

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### 1. Reasons for the surplus of CO<sub>2</sub> allowances

As already stated by the Commission in its "Report on the state of the European carbon market in 2012" an important surplus of CO<sub>2</sub> allowances in the system of carbon trading in the EU is due to two main reasons: i) decrease in industrial production and thus lower CO<sub>2</sub> emissions since 2008, ii) rise in the use of international credits in EU ETS compared to emissions. As a consequence, the total surplus of CO<sub>2</sub> allowances in 2013 is estimated by the Commission at up to 2 billion allowances. Therefore, the envisaged remedies for the stabilisation of the EU ETS have to accordingly address the surplus of emission allowances while taking into account the origins of the problem.

Thus, in the context of difficult economic situation, the measures aiming at strengthening the EU ETS have to lead to emissions reductions, which is the primary aim of the system, drive investments in energy

efficiency and renewable energies, and consider their impact on competitiveness, inside and outside the EU and society.

The features of an efficient ETS should be:

- a) a clear **price signal** for CO<sub>2</sub>, that incentivises investments for reduction of emissions,
- b) **predictability and visibility**, otherwise there are no investments,
- c) **no competition distortions** between ETS-subject operators and non- ETS ones.

## 2. The impact of the 'backloading' on the future of the EU ETS

As already stated by EFIEES on the occasion of the "Consultation on review of the auction time profile for the EU Emissions Trading System, **"backloading" of emission allowances proposed by European Commission without any further structural measure will have limited impact on price and big impact on uncertainty**: instead of being a first step towards stabilisation, there will be a lack of legal certainty related to the backloaded allowances, leading to **less visibility and less predictability which are always detrimental to investments aiming at reducing CO<sub>2</sub> emissions**, and more generally, detrimental to the concerned sectors.

The analysis presented in the Commission Staff Working Document, especially in the Annex 6 of the Proportionate Impact Assessment, shows that **even the backloading of the maximum proposed number of allowances (1,200 Mt) would not lead, according to renowned market analysts (Barclays, Bloomberg, or Thomson Reuters), to a sufficient increase in price of CO<sub>2</sub> in the long term** (logically, as the surplus is likely to be above 2,000 Mt). That would be an essential precondition to incentivising investments in clean technologies.

Moreover, such market intervention as backloading may lead to further interference as stated in conclusions of the latest study commissioned by ITRE Committee, European Parliament "Energy Efficiency and the EU ETS":

**"If implemented on its own, backloading will in the future likely lead to the need for further on-off interventions, which risks making the ETS subject to political interference".<sup>1</sup>**

"On-off" intervention only in the market will not provide the necessary structural changes towards a better functioning of the market, i.e. towards a market where the adjustment of prices is the driver for CO<sub>2</sub> reduction investments.

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<sup>1</sup> « Energy efficiency and the EU ETS », Directorate-General for Internal Policies, Economic and Scientific Policy", European Parliament, January 2013, p.57

Therefore, as we have already stressed, structural measures are indeed necessary to restore effectiveness of the EU ETS.

### 3. Options for structural measures: deficiencies of the proposed solutions

As a general remark, we regret that the 6 suggested options, being a rescue scenario for ETS, avoid, under circumstances of "emergency", any *prior* impact assessment on cost-effectiveness of each scenario. That would allow making better comparisons and justifications on the final choice. Otherwise one can expect that the solution to be chosen will be only justified by the legal/political feasibility.

#### Option a "Increasing the EU's greenhouse gas emissions reduction target for 2020 from 20% to 30% below 1990 levels"

This option has two major drawbacks:

1. We consider that the principle of fair competition for economic actors should be considered as a priority. A new "30%" target should consequently include proposals on a renewed approach on the share between ETS/non ETS sectors. If only a new general target is set up, without any change to the current share, which is 2/3 for the EU ETS sectors and 1/3 for non-ETS sectors, the **distortion of competition will not be addressed**. Even if non ETS sectors would also be covered by more stringent constraint at national level, according to the internal "burden sharing" within each MS, there is no guarantee that individual heating would become subject to any CO2 reduction effort. This issue is crucial for District Heating, which suffers distortions of competition with individual heating - see remarks on option d).

2. Higher targets of CO2 reductions will have a limited effect on prices as long as the economic crisis lasts, with a very progressive use of the surplus of allowances. But as soon as economic recovery will happen, the higher requirements will amplify the rebound of CO2 prices. That will be an obstacle for economic growth. This remark is valid also for option c).

Increased visibility for investors		Predictability/visibility on the price level
Limit competition distortion		Yes, if individual heating is addressed
Adaptability to economical recovery		Soaring prices in case of economic recovery
Price signal		With regard to CO2 goal/surplus of allowances/ economic growth

Legend (applying to all the tables):

- red: negative impact on the issue, therefore EFIEES not in favour of this option
- yellow: intermediate impact on the issue and consequently intermediate position of EFIEES
- green: positive impact on the issue, therefore EFIEES in favour of this option

### Option b "Retiring a certain number of phase three allowances permanently"

Such a further intervention in the market, after backloading, would bring a lack of confidence in the market. A crucial question would be to retire the accurate number of emission allowances from the market, without risk of future shortage (same remark for option d).

Increased visibility for investors		Predictability/visibility on the price level
Limit competition distortion		No impact on diffuse emissions nor on « internal » carbon leakage
Adaptability to economical recovery		Soaring prices in case of economic recovery
Price signal		With regard to CO2 goal /surplus of allowances/ economic growth

### Option c "Revising the 1.74% annual reduction in the number of allowances to make it steeper";

It seems that this measure would need to be complemented by a new GHG reduction target for 2030, which has not been decided at the EU level yet, whereas the failures of the current EU ETS need to be promptly addressed. The revision of the linear factor, as already suggested by ENVI Committee, European Parliament, applied alone, does not seem to have a major potential to affect the carbon price as it was already concluded by Öko-Institut in its analysis "Strengthening the European Union Emissions Trading Scheme and Raising Climate Ambition: Facts, Measures and Implications"<sup>2</sup>.

Increased visibility for investors		Predictability/visibility on the price level
Limit competition distortion		No impact on diffuse emissions nor on « internal » carbon leakage
Adaptability to economical recovery		Predictability/visibility on the price level
Price signal		With regard to CO2 goal /surplus of allowances/ economic growth

## 4. Options that could bring positive effects

As stated in the beginning of this document, the remedies for the EU ETS should address the origins of the problems of the carbon market, its deficiencies and take into consideration the aims of the ETS. This is the reason why the options d) "Extension of the scope of the EU ETS to other sectors", possibly combined with option f) (with prior in-depth analysis) and, to a lesser extent: e) "Limit access to international credits" are options worth considering and discussing.

<sup>2</sup> "If the linear reduction factor is increased to 2.25 % alone, the price effect in 2013 would be very low (1 €/EUA) and slightly higher in 2020 (2 to 3 €/EUA)", in: "Strengthening the European Union Emissions Trading Scheme and Raising Climate Ambition: Facts, Measures and Implications", Study for WWF and Greenpeace, Öko-Institut, Berlin, June 2012, p. 4

## Option d) "Extension of the scope of the EU ETS to other sectors"

With regard to competition principles, option d) offers substantial positive aspects. In the heat sector, this proposal could be a solution to competition problems faced by **heat producers and suppliers through district heating networks or through combustion installations > 20MW, which fall under the EU ETS, towards individual heating/small scale heating solutions (<20MW) that are not in the EU ETS scope.**

Local individual heating, despite direct CO<sub>2</sub> emissions, takes advantage of no-CO<sub>2</sub> costs to pay for the final user. Large District Heating systems, including the ones with high efficiency cogeneration units (CHP), are and will become even more exposed to CO<sub>2</sub> costs as the free allocation for heat production will decrease towards 2020 and eventually go to zero after this date.

In the particular case of **District Heating networks**, the competition between ETS/non ETS heating solutions is an accurate problem. Raising costs of heat and heating for DH customers will negatively affect the comparison between DH and individual heating solutions (boilers of less than 20MW). Additionally, it should be noted that DH is very much developed in social housing, and in MS were customers already suffer from growing energy poverty. For example, in Romania, where 20% of the population are clients of DH<sup>3</sup>, 25% of households cannot afford to keep their home adequately warm, and 23% of households experience arrears on utility bills.<sup>4</sup> The disconnections from DH will grow if DH becomes more expensive due to CO<sub>2</sub> costs, and the CO<sub>2</sub> emissions will rise, from additional individual heating, fully exempted from CO<sub>2</sub> reduction efforts.

This distortion has negative consequences for DH and cogeneration development (not only for DH), with adverse effects in terms of CO<sub>2</sub> emissions. A 40 MW cogeneration, that produces 20 MW heat, has a clear economic interest to become « Heat Only Boiler ». It will produce then a bit less than 20 MW heat, under the ETS thresholds. Another way to escape from ETS costs, for the final client of DH, is to disconnect from the network and choose other solutions (e.g. collective boiler for a whole building, own HOB for an industry/hospital/other). In all these cases, there is a loss in energy efficiency, more CO<sub>2</sub> emissions, and growing difficulties for DH to invest in low CO<sub>2</sub> actions/negative signals for the development of cogeneration.

This lack of balance is even more striking if one notes 40% of the EU final energy consumption is in housing, public and private offices, commercial and other building types. In particular, in residential homes, space heating accounts for two thirds of the final energy consumption.<sup>5</sup>

In order to stimulate energy efficiency and renewable energy, it is crucial to tackle this type of distortion of competition on heat market. A reflexion aiming at bridging the gap between ETS and non-ETS heating solutions, currently leading to a real "domestic carbon leakage" has to take place on how **diffuse CO<sub>2</sub> emissions can fall under EU ETS.**

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<sup>3</sup>«District heating and cooling. Country by country survey 2011 », Euroheat and Power, 2011, p. 322

<sup>4</sup>Harriet Rosalind Thomson, "Qualifying and quantifying fuel poverty across the European Union using consensual indicators", University of York, September 2011, p. 62, 64

<sup>5</sup>Energy Efficiency Plan, European Commission, 2011, p. 6

District heating has a market share of 10% in average in EU. EU ETS currently ignores 90% of the heating sector... Extending the scope to diffuse CO2 emissions for heating would help to make EU ETS market significantly broader, to absorb the surplus of allowances, to fight against a major distortion causing a carbon leakage, to stimulate energy efficiency and renewable energy.

As it would be impossible to submit to ETS thousands of millions of households, SMEs or energy transformers to ETS, one could imagine that fuel sellers should be submitted to ETS, on the basis of the volumes sold to non-ETS clients (whether final clients or not).

A CO2 tax that would neither be applicable to DH, nor to other ETS installations, but to small and individual heating competitors, without exemptions, is often regarded as an alternative solution. But it is far from being adopted at EU level. And, it would not, as such, tackle the issue of surplus of allowances.

Increased visibility for investors		d) improves predictability/visibility on the price level if the maximum level of allowances takes into consideration diffuse emissions
Limit competition distortion		If the extension of the EU ETS scope on diffuse emissions (<20MW)
Adaptability to economical recovery		No additional constraints
Price signal		With regard to CO2 goal /surplus of allowances/ economic growth

**Option f) "Introducing discretionary price management mechanisms such as a price management reserve"**

It is an interesting tool, which deserves nevertheless in-depth analysis.

That could be a long-term instrument, as a complement to options aiming at covering diffuse emission within the EU ETS directly solving the problem of the surplus of allowances.

This system would be based on minimum and maximum prices between which pure market mechanisms would operate, allowing a certain visibility, avoiding prices to sink at levels that do not incentivise the CO2 reduction investments, nor to raise at levels that would penalise the economic growth. Further analyses are still needed to explore the potential effect of such an instrument, as well as to examine governance rules.

Increase visibility for investors		Yes, thanks to floor and ceiling prices
Limit competition distortion		No impact on diffuse emissions nor on internal carbon leakage
Adaptability to economical recovery		Yes, thanks to ceiling price
Price signal		Yes, thanks to floor price

### Option e "Limit access to international credits"

Limiting the access to international credits could help to stabilise the system only if the remaining stock of CER is significant enough. If the past the use of international credits, as mentioned by the Commission, has contributed significantly to the surplus of allowances, "without international credits, the surplus in the EU ETS by 2020 would potentially be only around a quarter (25%) of the presently expected surplus" (COM 202 652 final), it does not mean that future use of CER is key for stabilising the system. We observe that most of them have already been used: limiting their access would not bring big changes in a future situation. CER will have been nearly all used in phase III.

A real assessment of the amounts of CER still to be used has to be done. Once there will be a clearer vision on the total amount still available, with the view to regulating their use, the approach on this issue should not be restricted to the "limitation" of access to international credits. It should be tackling the broader question on how international mechanisms can water down imbalances of the ETS, prices being either too low or too high. Once the CO<sub>2</sub> price will be higher, the idea of access to international credits should still be able to be considered again as it offers a safety provision in case when carbon price rises to very high levels, as concluded by the authors of a study "Energy efficiency and the EU ETS" (European Parliament, 2013).<sup>6</sup>

Increased visibility for investors		No improvement of the visibility
Limit competition distortion		No impact on diffuse emissions nor of internal carbon leakage
Adaptability to economic recovery		Soaring prices if economic recovery
Price signal		No impact, the number of CER is too low with regard to the surplus of allowances



## 5. How the revenues from auctioning should be invested

The revised EU ETS Directive stipulates that Member States are obliged to inform the Commission on how they use the revenues and that at least half of the revenues from the auctioning of general allowances should be used to combat climate change in Europe or other countries.<sup>7</sup>

In order to reinforce the system of lowering the EU carbon footprint, European Commission should issue the **guidelines on how the revenues from auctioning should be invested by the Member States. These guidelines should place a firm focus on investment in energy efficiency and renewables which support decarbonisation.** Concerning heat production and distribution, it is necessary to address the untapped potential of carbon savings, through efficiency increase (including efficient cogeneration) and fuel switching - particularly promoting the use of renewable sources of energy. These investments are especially important in Member States where energy efficiency will also contribute to combat energy poverty, but where investments in CO<sub>2</sub> reduction are not always affordable - a problem that particularly concerns heat customers in Eastern Member States.

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<sup>7</sup>[http://ec.europa.eu/clima/publications/docs/factsheet\\_ets\\_2013\\_en.pdf](http://ec.europa.eu/clima/publications/docs/factsheet_ets_2013_en.pdf)